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Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

No.

WOOD WALKER & CO.,

Petitioner,

v.

MARBURY MANAGEMENT INC. and HARRY BADER,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Questions Presented

1. Is the common law concept of *respondeat superior* read into the Securities Exchange Act of 1934 and specifically into § 10(b), (15 U.S.C. § 78j(b)) to hold an employer absolutely liable without *scienter* for the acts of its employees?

2. If a collateral misstatement is made prior to the purchase of a security at its fair market value and the security thereafter declines in price solely due to market forces, are damages for such decline recoverable by the purchaser?

Both questions were answered in the affirmative by the Court of Appeals for the Second Circuit.

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Official and Unofficial Reports of Case Below

The Second Circuit Court of Appeals decision dated April 21, 1980 is reported in CCH Fed. Sec. L. Rep. ¶ 97,357 [1980 transfer binder]. (Appendix, Exhibit A). The District Court opinion (Appendix, Exhibit B) is reported at 470 F. Supp. 509 (1979). The Second Circuit denials of rehearing and of the petition for rehearing *en banc* dated and entered June 4, 1980 are unreported.

Jurisdiction

The judgment of the Court of Appeals is dated and was filed April 21, 1980. The denial of the petition for rehearing *en banc* was dated and filed June 4, 1980. Jurisdiction of the court is invoked under 28 U.S.C. § 1254(1).

Statutes Involved

15 U.S.C. § 78j—Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered,

any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78t—Liabilities of controlling persons

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Statement of the Case

Marbury Management Inc. and Harry Bader (plaintiffs below) were customers of the brokerage house Wood Walker & Co. (petitioner herein), opeining accounts in the summer of 1968. In September 1968 a personal friend of plaintiffs, co-defendant Alfred Kohn, joined Wood Walker as a registered representative-trainee. While the record below is not altogether clear (the action was dismissed as to Wood Walker at the close of plaintiffs' case), plaintiffs apparently dealt principally with Alfred Kohn in their buying of stock at Wood Walker. Kohn who was not registered, was said to hold himself out as being a "portfolio management specialist" or "security analyst".*

Plaintiffs alleged that they took investment advice from Kohn, implying that they listened with particular attentiveness because he claimed to be a "portfolio management specialist".

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* A title that did not exist at Wood Walker nor one recognized by any regulatory agency.

Plaintiffs' principal argument was that they bought stocks based on misleading and erroneous information from Kohn concerning the stocks. This argument was rejected by the trial court and the Court of Appeals. The secondary allegation was that because Kohn printed up business cards identifying him as a "Portfolio Management Specialist-Security Analyst", and so described himself, he clothed his advice with an aura of expertise that helped sway plaintiffs' decisions to buy the stocks.

Though both lower courts totally absolved Kohn of making any statements concerning the stocks that violated § 10(b), they held that his suggestions of expertise in selecting stocks when he was not a registered representative equalled a violation of § 10(b) and that two of the plaintiffs could recover for the drop in price of the purchased securities even though the drop was totally due to free market factors.

The Court of Appeals went on to hold (reversing the trial court) that Wood Walker violated § 10(b) solely by reason of the common law doctrine of *respondeat superior,* in effect a doctrine of absolute liability.

Reasons for Granting the Writ

I.

The Second Circuit Decision Is Patently Inconsistent With the Holding of the Supreme Court as to *Scienter* in 10(b) Actions.

This court has clearly held that in order to violate Rule 10(b) of the Securities Exchange Act of 1934 one must act with *scienter. Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976).

Nonetheless, the court below held that an entity whose only involvement was that it was the wrongdoer's employer has no defense and is absolutely liable for any wrongdoing.

Ernst & Ernst v. *Hochfelder, supra,* clearly states in footnote 28 that each provision of the Securities Exchange Act of 1934 (except 16 (b)) requires some affirmative wrongdoing.

Recently in *Aaron* v. *Securities and Exchange Commission,* Fed. Sec. L. Rep. ¶ 97,511 (1980), this Court said:

> "It was the view of the Court that the terms 'manipulative', 'device' and 'contrivance'—whether given their commonly accepted meaning or read as terms of art—quite clearly evinced a congressional intent to proscribe only 'knowing or intentional misconduct', [Citing *Ernst & Ernst*]. This meaning, in fact, was thought to be so unambiguous as to suggest that 'further inquiry may be unnecessary'." (p. 97, 681).

Marbury is a 10(b) case yet the Second Circuit has held that the brokerage house is liable without intent. This cracks the cornerstone of this Court's interpretation of 10(b). It is wrong.

The 1934 Act is fundamentally a criminal act and intentionality is indispensable.

This Court said in the *Aaron* case,

> "In our view, the rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought." (p. 97, 681).

Judge Friendly, writing for a unanimous court in *IIT* v. *Cornfeld,* 619 F.2d 909 (2d Cir. 1980), cited the lower court

opinion in this case approvingly, and in light of *Ernst & Ernst* v. *Hochfelder* reaffirmed *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (*en banc*), for the proposition that *scienter* is an indispensable part of a violation of Section 10(b). Although the Court was addressing itself to liability under an aiding and abetting theory, the clear inference was that *scienter* was necessary to find liability. Accordingly, it is incongruous to find liability on the part of Wood Walker where the court below found that Wood Walker had no ". . . wrongful participation . . . nor a legally equivalent recklessness". (App. A4).*

Even against someone who aids and abets the wrongdoer there must be proof of ". . . their conscious and intentional complicity . . ." (App. A11).

One whose liability arises only out of being a controlling person is allowed the defense that he ". . . acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." (Securities Exchange Act of 1934, Section 20(a)).

Section 20(a), which was aimed at dummy corporations or nondisclosed parties, gives to even those who hide their control both a "good faith" and "did not induce" defense. Yet the majority in the lower court would ascribe to a disclosed principal operating openly and publicly no comparable defense. This is untenable.

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* References are to Appendix.

II.

There Is a Conflict Among the Circuits as to Whether *Respondeat Superior* Can Be a Basis for Liability Under Section 10(b) of the Securities Exchange Act of 1934 and the Instant Second Circuit Decision Overturns Its Own Rule.

Certain circuits have held there is no *respondeat superior* liability under Section 10(b), others have not decided the issue or made equivocal holdings, while still other circuits have held that there is *respondeat superior* liability under Section 10(b).

In a 10(b) action reviewed by the Third Circuit, *Rochez Brothers, Inc.* v. *Rhoades,* 527 F.2d 880 (3rd Cir. 1975), an executive vice president of a corporation sold 50 percent of the stock of the corporation to its president. The court held that the corporation was not liable for its president's activities in purchasing the stock. Judge Stanley stated:

> "We are of the opinion that, after reviewing the legislative history of the 1934 Act and the pertinent cases, the principles of agency, i.e., *respondeat superior,* are inappropriate to impose secondary liability in a securities violation case," *Id.* at 884.

The Ninth Circuit also does not apply *respondeat superior* to Section 10(b). In *Christoffel* v. *E. F. Hutton & Co., Inc.,* 588 F.2d 665 (9th Cir. 1978), a brokerage house was held to be not liable for losses sustained by the estate of an incompetent due to the brokerage firm's former account executive who had dissipated and misappropriated assets of the estate. Judge Hufstedler stated:

> "The district court correctly granted summary judgment against Christoffel [the plaintiff] on his com-

> mon law theory because it is the established law of this circuit that section 20(a) supplants vicarious liability of an employer for the acts of an employee applying the respondeat superior doctrine," *Id.* at 667.

A brokerage house was held not to be liable for the "churning" by its account executive of a customer's securities in *Mihara* v. *Dean Witter & Co., Inc.,* 619 F.2d 814 (9th Cir. 1980). Judge Campbell held:

> "The contention that the Court incorrectly instructed the jury regarding the applicability of *respondeat superior* to a 10b-5 claim is also unsupported by the record. The Court gave the *respondeat superior* instruction in connection with the fiduciary duty claim, and limited it to that claim," *Id.* at 825.

The Tenth Circuit in *Richardson* v. *MacArthur,* 451 F.2d 35 (10th Cir. 1971), imposed Section 20(a) liability on an employing corporation in a Rule 10b-5 case, stating that "Liability under § 20 (a) is not restricted by principles of agency or conspiracy," *Id.* at 41. However, the court did not analyze the facts with respect to *respondeat superior.*

In a footnote on *respondeat superior,* the Fifth Circuit noted that the Second Circuit had not applied the concept at that time, and the Fifth Circuit left the question unanswered, *Woodward* v. *Metro Bank of Dallas,* 522 F.2d 84 (5th Cir. 1975).

> "Apparently, the Second Circuit takes the view that section 20 (a) of the Act, 15 U.S.C. § 78t (1970), which deals with 'controlling persons,' is the exclusive way to hold someone secondarily liable. See *Gordon* v. *Burr,* S.D.N.Y. 1973, 366 F. Supp. 156, *aff'd* 2 Cir. 1974, 506 F.2d 1080. While this may be an unnecessarily restrictive approach to the securities acts, it

is a question that we need not resolve here," *Id.* at 94, fn. 22.

The Sixth Circuit has not applied *respondeat superior* in a civil context but only (as had the Second Circuit) applied it in limited areas of SEC enforcement proceedings, *Armstrong, Jones & Co.* v. *SEC,* 421 F.2d 359 (6th Cir. 1970), *cert. denied,* 398 U.S. 958 (1970).

Three circuits have applied *respondeat superior*: the Fourth Circuit in *Johns Hopkins University* v. *Hutton,* 422 F.2d 1124 (4th Cir. 1970), *cert. denied,* 416 U.S. 916 (1974), the Seventh Circuit in *Fey* v. *Walston & Co., Inc.,* 493 F.2d 1036 (7th Cir. 1973), and the Eighth Circuit in *Myzel* v. *Fields,* 386 F.2d 718 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1970). This conflict among the circuits requires the attention of the Supreme Court.

Finally, until the decision in the instant case it was perfectly clear that the Second Circuit had held that, except in a very limited area of SEC enforcement proceedings, there was no liability under Section 10(b) of the Securities Exchange Act of 1934 purely on the basis of *respondeat superior.*

As a matter of fact the lower court majority had to devote multiple paragraphs to "explain" how other circuits have "mistakenly" believed that the Second Circuit did not impose *respondeat superior* liability.

The simple truth is that the Second Circuit in an unbroken string of cases had declined to impose civil liability based on *respondeat superior* and this divided panel overruled existing law and promulgated new law.

The Second Circuit in *Lanza* v. *Drexel & Co.,* 479 F.2d 1277 (1973) (*en banc*) per Judge Moore held that before secondary liability would attach, some culpability on the

part of the controlling person be found. The Court approvingly cited *Kamen & Co.* v. *Paul H. Aschkar & Co.*, 382 F.2d 684 (9th Cir. 1967), a case almost identical to the present one; in *Kamen* the Court found that broker-dealer's liability was based on § 20(a), and that *scienter* must be proved.

Shortly after *Lanza, SEC* v. *Lum's Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973), citing *Kamen* and *Lanza,* held decisively and clearly that a broker-dealer could not be held liable even in enforcement proceedings under *respondeat superior:*

> "To hold Lehman liable on a theory of *respondeat superior* would also do violence to the legislative intent underlying the Act." 365 F. Supp. at 1063.

The same court went on to say:

> "Insistence upon a standard or *respondeat superior* would result in the imposition of absolute liability upon broker-dealers in this context." 365 F. Supp. at 1064.

That court concluded that a standard of absolute liability on the part of broker-dealers in the securities industry for the acts of its salesmen would be

> ". . . to read a non-existent insurer's liability into the statute for broker-dealers." 365 F. Supp. at 1064.

Also in *Gordon* v. *Burr,* 366 F. Supp. 156 (S.D.N.Y. 1973), Judge Bauman disavowed the concept of *respondeat superior* liability stating:

> "This is not, however, the view of the majority of circuits, as Judge Tyler has recently pointed out in S.E.C. v. Lums, Inc., 365 F. Supp. 1046, CCH Fed. Sec. Law Rep. ¶ 94, 134 (S.D.N.Y. 1973). He reads both the majority and the dissenting opinions in Lanza v. Drexel & Co., *supra, to suggest that § 20(a),*

> *and not respondeat superior is the appropriate standard for determining secondary liability under the Securities Exchange Act. Judge Judd's opinion in Moerman* v. *Zipco., Inc. supra,* which was affirmed by the Court of Appeals, also supports the exclusivity of § 20(a). See also, Moscarelli v. Stamm, 288 F. Supp. 453 (E.D.N.Y. 1968) (emphasis supplied). 506 F. Supp. at 168.

The Second Circuit affirmed, *Gordon* v. *Burr,* 506 F.2d 1080 (1974), holding:

> "If P.A.W. is also liable to Gordon, it must be derivatively—as a "controlling person" of Lord, within the meaning of § 20(a) of the 1934 Act." 506 F.2d at 1085.

The majority opinion below incorrectly states that the Second Circuit has previously found that *respondeat superior* applies. The majority misread those cases. An example is their statement that:

> "In *Edwards & Hanly* v. *Wells Fargo Securities Clearance Corp.,* 458 F. Supp. 1110 (S.D.N.Y. 1978), the court held that a defendant was liable for its president's Rule 10b-5 frauds both on the respondeat superior and on the Section 20(a) theories . . ." (App. A18).

However, the trial judge* in *Edwards & Hanly* stated that because he found liability under § 20(a) he did not have to decide whether *respondeat superior* alone would provide a sufficient basis for damages:

> "On the facts of the case, this court need not resolve 'the rather thorny controlling person-respondeat superior issue'." 458 F. Supp. at 1125.

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* Lee P. Gagliardi, also the trial judge in the instant case.

III.

The Court Below Applied a Measure of Damages That Flagrantly and Improperly Shifts the Losses Away From the Customer.

Judge Meskill, in his dissent herein, clearly and lucidly set forth the argument rebutting the majority's ca. sation theory of damages. We respectfully refer the Court to his opinion.

Judge Meskill points out that the majority has opened up a potentially limitless expansion of § 10(b) liability (App. A29). Any factor anywhere in the universe that starts a chain of events can now be deemed to cause the ultimate event. As Judge Meskill so appropriately quotes Judge Weinfeld: "This is causation run riot. (App. A35).

Essentially, the majority held that

(a) if a valid recommendation is made, and

(b) there is reliance, and

(c) the advisor did not have the credentials claimed,

then all loss thereafter is the responsibility of the advisor.

Both the trial court and the Court of Appeals held that because plaintiffs did not learn that Kohn was neither a "portfolio management specialist" nor "security analyst" until January 1970* and continued to hold their stocks despite price declines, the loss falls on the defendants.

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* A curious holding is that Kohn left Wood Walker in early 1969 and plaintiffs were paying no attention to Kohn after March of 1969. From Marbury's Trial Testimony:

(footnote continued on following page)

The majority implies that plaintiffs continued to hold their stock based on the advice of Kohn and misstatements by Kohn as to his status, which reinforced their belief that his information was accurate. In fact, Judge Gagliardi did not make such a finding. See dissent of Judge Meskill (App. A39).

Even if he had made such a finding, the mere retention of a security due to a materially false representation would not state a claim under Rule 10b-5. *Darrell* v. *Goodson,* CCH Fed. Sec. L. Rep. ¶ 97,349 (S.D.N.Y. 1980), citing *Abrahamson* v. *Fleschner,* 568 F.2d 862 (2d Cir. 1977).

The causality adopted by the Second Circuit is effectively a "but for" test, as there is no suggestion that the stock declined in value because of anything Kohn did. Rather, it declined after what Kohn did. The loss, nonetheless, is attributed to him and to his employer, Wood Walker.

The anomalous revival of "but for" causation in the context of the 10(b) actions absolutely flies in the face of

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(footnote continued from preceding page)

> Q. When was the last time you spoke with Mr. Kohn at the number which you said was Wood Walker's? A. I don't remember that at all.
>
> Q. No idea? A. No, no idea.
>
> Q. Let me try it another way. According to your charge, the last purchase you made was March 26, 1969. Clearly at that point you were still listening to Mr. Kohn as you were making no independent investigation and buying stocks solely on his comments to you. What made you stop on March 26, 1969? A. Because we weren't getting too successful results with the stocks that he recommended.
>
> Q. You made a concious decision not to use Mr. Kohn any longer or for anyone to talk to? A. When you do business with someone that you don't have too much success—
>
> Q. You made a conscious decision at that point of no further dealings with Mr. Kohn? A. You are asking me whether I remember after 8 years?
>
> Q. I am asking you to recall as best you can. A. I would say yes.
>
> (Trial Transcript pp. 44/45)

this Court's rulings in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972) and *Superintendent of Insurance* v. *Bankers' Life and Casualty Co.*, 404 U.S. 6 (1971).

It is as if someone asked directions of a person impersonating a policeman, was given proper directions and along his journey was struck by a car. The majority would hold that an action would lie against the "false policeman".

The majority lose sight of their own affirmance of the trial court's finding that Kohn's alleged recommendations were not wrongful. Not one of the ancient cases cited by the majority allowed recovery based on a misdescribed adviser.

If one wants a battle of ancient New York cases, Judge Meskill's dissent cites equally ancient but correct law that "but for" causality is not the New York rule. See *Hotaling* v. *A. B. Leach & Co.*, 247 N.Y. 84 (1928), *Abel* v. *Paterno*, 245 App. Div. 285, 281 N.Y.S. 58 (First Dept. 1935).

Prosser, *Law of Torts*, quoted in Judge Meskill's dissent at App. A28 sums up the entire point.

> . . . if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline of the market, or insolvency of the corporation, brought about by business conditions or other factors in no way related to the representations, will not afford any basis for recovery. It is only where the fact misstated was of a nature calculated to bring about such a result that damages for it can be recovered.

Prosser, *Law of Torts* ¶ 110 at 732 (4th ed.) (footnotes omitted).

Plaintiffs bought stock at fair market value and got exactly what they paid for. The fact that later the stock declined in price had nothing to do with Kohn's representations as to his expertise.

IV.

The Second Circuit's Opinion as to the Relevance of Being a "Not Registered" Registered Representative Flatly Contradicts the Holding of the Ninth Circuit.

The majority on appeal summarily disregarded a case directly on point: *Hayden, et al.* v. *Walston & Co., Inc., et al.*, 528 F.2d 901 (9th Cir. 1975). The facts and the issue are as identical as two cases can be.

In *Hayden* the only misleading information, as in our case was a lack of registration.* The decision should be the same.

If there were other misleading statements by Kohn, there might be a distinction, but it was specifically found by both lower courts that he did not make other misleading statements.

The majority suggest that in *Hayden,* the salesman may not have held himself out to be a duly registered representative. How the court divined that from the sparse opinion is unclear, but since the *Hayden* court found that he was a salesman and was not registered, the reasonable inference is that he did in fact so hold himself out.

Can it be that the majority seriously means to say that the two cases are distinguishable on whether the unregistered employee was careful not to say, "I am a duly registered representative."?

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* "Appellants were solicited by and purchased stock through a salesman employed by the defendant Walston & Co., who at the time was unlicensed to sell securities . . . On the basis of this fact alone, appellants seek to state a federal claim to recover their losses on the stock . . ." Held: Appellants' Rule 10b-5 claim is unavailing. 528 F.2d at 901.

We draw to this Court's attention the absolutely appropriate language found in the *Hayden* case.

> "The customer may receive thoroughly competent service from an unregistered salesman, and be unharmed by violation of the rule." 501 F.2d at 902.

Conclusion

Because of the importance of these issues to the securities industry, the fact that the Second Circuit decision is inconsistent with the holdings of this Court, and the fact that there is a conflict between the circuits, we request that this Court grant certiorari.

Dated: August 29, 1980

Respectfully submitted,

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APPENDIX

APPENDIX A

Decision of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

Second Circuit

Nos. 79-7363, 79-7380

April 21, 1980

Marbury Management, Inc., et al.,

Plaintiffs-Appellants,

v.

Kohn, et al.,

Defendant-Appellant.

George Berkowitz, for plaintiffs-appellants.

Fischer & Klein, Jay H. Fischer, for defendant-appellant Kohn.

Lunney & Crocco, Charles A. Crocco, Jr., for appellee Wood, Walker & Co.

Before:

MESKILL and KEARSE,
Circuit Judges.

DOOLING,*
District Judge.

Appeal by defendant Kohn from a judgment of the United States District Court for the Southern District of New

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* Of the Eastern District of New York, sitting by designation.

York, Lee P. Gagliardi, Judge, 470 F. Supp. 509, awarding damages under Section 10(b) of the Securities Exchange Act to purchasers of securities who relied on Kohn's alleged misstatement of his status in the securities business in making purchases through him. Cross appeal by plaintiffs from the judgment dismissing the action against defendant-appellee Wood, Walker & Co., Kohn's employer.

Affirmed in part and reversed and remanded in part.

Dooling, District Judge: Marbury Management, Inc., ("Marbury"), and Harry Bader sued Alfred Kohn and Wood, Walker & Co., the brokerage house that employed Kohn, for losses incurred on securities purchased through Wood, Walker allegedly on the faith of Kohn's representations that he was a "lawfully licensed registered representative," authorized to transact buy and sell orders on behalf of Wood, Walker.[1] After a non-jury trial before the Honorable Lee P. Gagliardi, District Judge, the court found that Kohn was employed by Wood, Walker as a trainee and that his repeated statements that he was a stockbroker and his use of a business card stating that he was a "portfolio management specialist" were undeniably false; the court found further that Kohn made the statements with intent to deceive, manipulate or defraud in making them, and that his misstatements were material. The court found that Kohn's misrepresentations about his employment status caused Marbury and Bader to purchase securities from Kohn between summer 1967 and April 1969. The district court also found that the predictive statements

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[1] Harvey Jaffe was also a plaintiff but at the close of plaintiffs' case the action was discontinued as to him with prejudice and without costs, and the judgment stated that he was not entitled to relief. Jaffe has not appealed. The New York Stock Exchange, originally joined as a defendant, was dismissed from the action before trial.

Kohn made about various securities were not fraudulently made, and that there was no evidence that they were made without a firm basis.

Judge Gagliardi reasoned: a trainee at a brokerage firm can accept buy or sell orders by phone only under the supervision of a broker and cannot recommend the purchase of a security outside the brokerage office; moreover, the qualifications and expertise of a security salesman are particularly significant criteria in evaluating any information as inherently speculative as future earnings predictions; and a reasonable investor would consider the total mix of information that he received significantly altered if he learned that the investment advice was being furnished to him by a trainee in the field rather than by a specialist Judge Gagliardi concluded that the important circumstance was that the terms "broker" and "specialist" themselves connote a level of competence to the reasonable investor. Thus, he held Kohn liable to plaintiffs under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). Inferentially Judge Gagliardi found that Kohn's misstatements of his status not only induced the purchase of the securities involved but their retention as investments as well, until it became evident that Kohn was not, as his business card asserted, a "security analyst" and "portfolio management specialist" associated with Wood, Walker, but simply a trainee. Since both plaintiffs learned the true facts about Kohn's status on or about January 28, 1970, Judge Gagliardi computed the damage award to each plaintiff by taking the difference between the price each plaintiff paid for the securities and either the selling price of the securities, if sold before January 28, 1970, or the value within a reasonable time after that date, if the securities were still held on that date.

Appendix A—Decision of the United States Court of Appeals for the Second Circuit

Judge Gagliardi dismissed the plaintiffs' claims against Wood, Walker on the ground of plaintiffs' failure to prove that Wood, Walker participated in the fraudulent manipulation or intended to deceive plaintiffs; treating plaintiffs as basing their claims against Wood, Walker solely on the theory that the firm aided and abetted Kohn's fraud, the court found that the evidence supported neither a finding of conscious wrongful participation by the firm nor a legally equivalent recklessness but at best a finding of negligence in supervision.

Judge Gagliardi's findings of fact are not clearly erroneous. The cross-appeals of defendant-appellant Kohn from the judgment against him and of plaintiffs-appellants from the judgment exonerating Wood, Walker from liability raise questions of law that are hardly novel but are not free from difficulty in application. It is concluded that the judgment against appellant Kohn must be affirmed and that in favor of Wood, Walker reversed.

1. The substantial question that the appeal of defendant-appellant Kohn raises is whether Kohn's misrepresentation was the legal cause of the loss for which Marbury and Bader have been allowed recovery. The securities bought did not lose value because Kohn was not a registered representative with Wood, Walker, and this case, accordingly, is not one in which a material misrepresentation of an element of value intrinsic to the worth of the security is shown to be false, and in which it is shown that disclosure of the falsity of the representation results in a collapse of the value of the security on the market. In such cases one induced to buy the security on the faith of the misrepresentation of the value element is obviously damaged, and the chain of causation is clear.

Here the claim and finding are that Kohn's statements by their nature induced both the purchase and the retention of the securities, the expertise implicit in Kohn's supposed status overcoming plaintiffs' misgivings, prompted by the market behavior of the securities.[2] Plaintiffs' recovery of their whole loss measured by the decline in value of the securities to the date when they learned the truth certainly does not fit the familiar rubric, for example, of Section 11(e) of the Securities Act of 1933, 15 U.S.C. § 77k(e)—limiting recovery on account of a false or misleading registration statement to the deprecipation in value of the security resulting from the untruthfulness of the statement made about it. *Cf.* Restatement (Second) of Torts § 548A (Comment b, Illustration 1) (1977) (security bought on faith of untrue representation that issuer had received full consideration for it; later full consideration received by issuer, but a court invalidated the security on other grounds; buyer not allowed to recover his loss because it was not considered a proximate consequence of the untrue representation). But plaintiffs in such a case as this, whether or not their claims fall under the more familiar rubric, are, nevertheless, entitled to recover the damages that they suffered as a proximate result of the allegedly misleading statements, *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1291 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

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[2] Marbury's representative, asked why they had held one of the securities so long, answered that Kohn told them to do it, that it was going to go up; that Kohn had advised them to hold the other securities as well; and that Marbury continued to rely on Kohn's advice and to hold onto the securities until they learned that he was not a licensed and registered representative. (*See* 67a, 70a, 73a, 80a-81a, and 84a-85a.) Bader's testimony, while less detailed and pointed, leads to the same ultimate finding. (*See* 93a-94a, 97a-99a, 106a, 113a, and 114a-116a).

As Judge Weinfeld observed in *Miller* v. *Schweickart*, 413 F. Supp. 1062, 1067 (S.D.N.Y. 1970):

> Proximate cause, of course, is a concept borrowed from the law of torts, and generally requires that one's wrongful conduct play a "substantial" or "essential" part in bringing about the damage sustained by another.

The generalization is that only the loss that might reasonably be expected to result from action or inaction in reliance on a fraudulent misrepresentation is legally, that is, proximately, caused by the misrepresentation. Restatement (Second) of Torts § 548A (1977). *See Levine* v. *Seilon*, 439 F.2d 328, 333-34 (2d Cir. 1971). *Oleck* v. *Fischer*, FED. SEC. L. REP. (CCH) ¶ 96,898, at 95,702-03 (S.D.N.Y. 1979), in effect requires that the damage complained of be one of the foreseeable consequences of the misrepresentation. The case for Marbury and Bader is that, since the misrepresentation was such as to induce both their purchases and their holding of the securities, their holding and its duration determined the extent of their losses. As in *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975), the claim is that the misrepresentation was the agency both of transaction causation and of loss causation.

Liability for representations having the effects of Kohn's representation was familiar in the law even before the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted. For example, in *Rothmiller* v. *Stein*, 143 N.Y. 581 (1894), the defendant officers of a small corporation told plaintiff that the company was prospering and would pay at least a 10% dividend, and they recommended that plaintiff reject an offer of $80 a share for his stock

and accept an offer at $50 a share plus a deferred payment of $50 a share if there were an interim dividend of 10% on the stock. Plaintiff acted on the advice, relying on the defendants' fraudulent statements about the company's affairs. In holding defendants liable, the court said that defendants

> . . . cannot in such case shelter themselves under the statement that they did not make the representations, *i.e.*, commit the fraud with the motive or for the purpose of inducing the plaintiff to sell his stock. They intended to deceive the plaintiff and they were induced thereto by other causes, yet the natural, proximate and direct result of such deception they knew or had reasonable ground for believing would be this sale, although its accomplishment was not the particular purpose of their fraud. In such case their liability would seem to be plain.

Id. at 588. So in *David* v. *Belmont,* 291 Mass. 450, 197 N.E. 83 (1935), plaintiff had retained stock of a certain company and bought additional shares of the same stock in reliance on certain representations made by defendant which were false. The court said:

> Presumably [plaintiff] continued to hold the stock after the purchase in reliance on the representations. The fraud was therefore continuing in its effect until such time as the plaintiff discovered the falsity of the representations. A loss which he suffered would manifestly be the difference in the then value of the stock and the price which he paid for it.

Id. at 454, 197 N.E. at 85. Similarly in *Cartwright* v. *Hughes,* 226 Ala. 464, 147 So. 399 (1933), the plaintiff bought stock

of the defendants' bank on their representation that it was "a good investment," that the bank was solvent, and that its assets were "good clean assets." The bank ceased to function and its stock became worthless. The issue in the appellate court was the appropriate measure of damages. Agreeing that the ordinary rule measures damages by the difference between value at the time of the fraud and what the value would have been had the representations been true (the so-called "warranty" measure of damages), the court said:

> The question of time is not often involved, but in such a transaction as this in 4 Sutherland on Damages, § 1172, at p. 4409, it is said that "the value of the stock sold is not uniformly fixed as of the time of the sale, especially if the purchase was made as an investment. The fraud in such a case has been considered operative until the purchaser learned of it; that is regarded as the time when his cause of action arose."

Id. at 467, 147 So. at 401.

The proposition that fraudulent representations may induce the retention of securities as an investment and entail liability for the damages flowing from retention was given a more general form in *Continental Insurance Co.* v. *Mercadante,* 222 A.D. 181, 225 N.Y.S. 488 (1st Dept. 1927). The court there said:

> Where the damage is caused by inducing plaintiff's inaction, it is necessarily more difficult to allege or prove causation than in those cases where active conduct is induced. Indeed, in all fraud cases, the element of proximate cause is more impalpable than in negligence cases because we are dealing with the

> plaintiff's state of mind. The defendants cannot, therefore, require the same exact proof of causation.

Id. at 186, 225 N.Y.S. at 494. See to the same effect *Hotaling* v. *A. B. Leach & Co.*, 247 N.Y. 84, 93 (1928) ("As long as the fraud continued to operate and to induce the continued holding of the bond, all loss flowing naturally from that fraud may be regarded as its proximate result."); *Stern Bros.* v. *New York Edison Co.*, 251 A.D. 379, 381, 296 N.Y.S. 857, 859 (1st Dept. 1937) ("Fraud which induces non-action where action would otherwise have been taken is as culpable as fraud which induces action which would otherwise have been withheld."); *Hadden* v. *Consolidated Edison Co.*, 45 N.Y.2d 466, 470, 410 N.Y.S.2d 274, 276 (1978). *See* 1 F. Harper and F. James, The Law of Torts 600-603 (1956).

Although the theory of plaintiffs' case relates their damages to the inaction of retaining the securities on the faith of their belief in Kohn's assertion of his status, the claim is nevertheless one within Section 10(b) and Rule 10b-5 because the representation relied upon was made in connection with the purchase of securities, and both Marbury and Bader sue as purchasers of securities. *Cf. Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 731, 755 (1975) (private damage action under Rule 10b-5 is confined to actual purchasers or sellers of securities). The case is not one in which nothing has been shown except an inducement to hold as in *Parsons* v. *Hornblower & Weeks-Hemphill, Noyes*, 447 F. Supp. 482, 487 (M.D.N.C. 1977), *aff'd*, 571 F.2d 203 (4th Cir. 1978), if that case is a correct reading of *Blue Chip*. Nor is this case similar to *Hayden* v. *Walston & Co.*, 528 F.2d 901 (9th Cir. 1975): there the plaintiffs had purchased securities through a salesman who was not a duly licensed registered representative, but did not show that

the salesman's nondisclosure of his status rendered his other statements misleading within the meaning of Rule 10b-5, and there was evidently no claim or proof that he held himself out to be a duly registered representative. The second ground of suit rejected in the *Hayden* case, that a private right of action could be predicated on the violation of the National Association of Securities Dealers rules, has not been relied upon in this case, and was not a ground of decision in the district court.

It follows from what has been said that the judgment against defendant-appellant Kohn must be affirmed.[3]

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[3] The majority and dissenting opinions do not differ in recognition of the basic principles of proximate causation in agreement that those principles apply to the torts of fraud and deceit, and that the critical issue is their application to those of Kohn's statement that Judge Gagliardi found to be untruthful and affective of the action of Marbury and Bader. Kohn, it is agreed, is liable only for the damages that his misrepresentations proximately caused. The dissenting opinion rejects what the majority opinion considered Judge Gagliardi's implicit finding that Kohn's representations, unrelated to the intrinsic charateristics of the stocks bought, induced both the purchase and the retention of the stocks on which the damages were computed. That is implicit in Judge Gagliardi's analysis of the representations and their culpable untruth, the period over which he found the untruth affective of plaintiff's conduct (that is, until Kohn's true status was disclosed), the measure of damages he employed, and his explicit reliance on *Clark* v. *John Lamula Investors, Inc.* and *Harris* v. *American Investment Co.* The majority opinion neither refuses to give effect to the traditional and acknowledged standard of causation, nor does it repudiate it, or refuse to abide by it. Differentiating transaction causation from loss causation can be a helpful analytical procedure only so long as it does not become a new rule effectively limiting recovery for fraudulently induced securities transactions to instances of fraudulent representations about the value characteristics of the securities dealt in. So concise a theory of liability for fraud would be too accommodative of many common types of fraud, such as the misrepresentation of a collateral fact that induces a transaction.

2. Marbury and Bader have appealed from the judgment in favor of Wood, Walker. Judge Gagliardi considered the case against Wood, Walker as one in which plaintiffs sought recovery against Wood, Walker only "as an aider and abettor of Kohn's securities law violations." Judge Gagliardi found that the evidence did not show that Wood, Walker intended to deceive plaintiffs, or knew of Kohn's violations, or provided substantial assistance to Kohn in violating the securities law, but at most showed only negligence on Wood, Walker's part. Applying the standard of *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-48 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978), the district court held that plaintiffs had failed to establish essential elements of their claim against Wood, Walker as an aider and abettor of Kohn's securities law violations. The court did not consider Wood, Walker's possible liability under the respondeat superior theory, or as a "controlling person" under Section 20(a) of the Securities Act of 1934, 15 U.S.C. § 78t(a). It is concluded, on this branch of the case, that the court's disposition of the "aider and abettor" issues was correct, but that it was error, on the record before the court, not to consider and determine whether Wood, Walker was liable as a controlling person or as Kohn's employer.

(a) Marbury and Bader have in this court again argued that Wood, Walker is liable because the evidence shows that it did aid and abet Kohn's commission of the fraud. If Kohn and Wood, Walker are regarded as distinct actors liable for each other's acts only to the extent of their conscious and intentional complicity in them, and the "aiding and abetting" theory requires that approach, Judge Gagliardi's conclusion is unassailable on the evidence. The circumstances on which plaintiffs rely to show that Wood, Walker

should be held liable as an "aider and abettor" may suggest inadequate supervision and lax control but they do not show that the firm was guilty of "knowing or intentional misconduct" or of equivalently reckless misconduct. *See generally Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 197, 200-201 (1976); *Edwards & Hanly* v. *Wells Fargo Securities Clearance Corp.,* 602 F.2d 475, 483-85 (2d Cir. 1979), *cert. denied,* 48 U.S.L.W. 3465 (1980); *Rolf* v. *Blyth, Eastman Dillon & Co., supra,* 570 F.2d at 44-48.

(b) A threshold question on this aspect of plaintiffs' appeal relates to plaintiffs' right to argue that the court should have considered the respondeat superior and controlling person contentions. The district judge took the view, 470 F. Supp. at 515 n.11, that plaintiffs had not alleged that Wood, Walker was liable either as a controlling person or as a principal under the respondeat superior doctrine, and that, in consequence, the court did not need to consider Wood, Walker's liabilities on either of those theories. In the opinion, *id.,* at 515, the court said that plaintiffs' position, as expressed at the trial and in their post-trial memorandum of law, indicated that they sought recovery against Wood, Walker as an aider and abettor of Kohn's violations.

While plaintiffs have not denominated their argument in this court and in the district court a respondeat superior argument, and the complaint did not contain the traditional allegation that Kohn made the representations relied upon in the course of his employment with Wood, Walker, the evidence upon which plaintiffs rely in this court, as in the district court, and the allegations of fact made in the complaint are alike completely descriptive of the transactions and of the roles of the actors in them, and they are the evidence and allegations relevant to a determination of the

respondeat superior issue, and, inevitably, of the Section 20(a) issue. Plaintiffs' counsel argued the respondeat superior issue orally at the trial, and the bare failure to reiterate it in the closing brief in the district court cannot be considered an abandonment of the point.

The way in which the case was tried, and the shift in the emphasis of argument on the motion to dismiss arising from the introduction of *Ernst & Ernst* into the discussion may explain Judge Gagliardi's taking the position that he had to consider only the aider and abettor analysis, but the record evidence tending to support the plaintiffs' claim on the other two grounds was before the court, and, on the whole of that evidence, the three theories of liability—aider and abettor, controlling person, and respondeat superior—equally presented themselves for resolution. There was evidence of Kohn's hiring, his compensation, his authority to accept orders over the telephone at the firm's Bronx office, the execution by Wood, Walker of the orders Kohn obtained from plaintiffs, the fact that Wood, Walker received the brokerage commission on all the transactions, the extent to which and the circumstances in which Kohn was authorized to recommend securities to the firm's customers, the uncertain provenance of Kohn's Wood, Walker business card, and the relation of the Bronx office of Wood, Walker to its main office. While plaintiffs' motion to conform the pleadings to the proofs—if the very factual complaint required amendment—was made in general form and was almost at once apparently confined to a narrow point on damages, the evidence, although not complete in every particular, disclosed each operative factual element of the transactions involved, and it thus invoked the application of whatever principles of law determined the outcome of the

issues raised by the evidence.[4] *Cf.* Fed. Rules Civ. Proc. 15(b) (issues tried by implied consent treated as if raised in the pleadings, which may be amended to conform to the evidence at any time, although failure to amend does not affect the result of the trial of the issues); *Wasik* v. *Borg*, 423 F.2d 44, 46 (2d Cir. 1970) (third party defendant held directly liable to plaintiff although plaintiff did not plead against third party defendant where issues of fact tried between those parties).

It was then error not to pass on the respondeat superior and Section 20(a) issues which lurked in the record, unless resort to respondeat superior is precluded by Section 20(a) and the district court's rejection of the claim that Wood, Walker aided and abetted Kohn's violations implies a finding that Wood, Walker has a "good faith" defense under Section 20(a). That section provides in relevant part:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not

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[4] Generally a complaint that gives full notice of the circumstances giving rise to the plaintiff's claim for relief need not also correctly plead the legal theory or theories and statutory basis supporting the claim. *Rohler* v. *TRW, Inc.*, 576 F.2d 1260, 1264 (7th Cir. 1978); *Hostrop* v. *Board of Junior College District No. 515*, 523 F.2d 569, 581 (8th Cir. 1975), *cert. denied*, 425 U.S. 963 (1976); *Bramlet* v. *Wilson*, 495 F.2d 714, 716 (8th Cir. 1974); *Siegelman* v. *Cunard White Star Ltd.*, 221 F.2d 189, 196 (2d Cir. 1955); *cf. New York State Waterways Assn.* v. *Diamond*, 469 F.2d 419, 421 (2d Cir. 1972) (court's duty to read pleading liberally to determine whether facts alleged justify taking jurisdiction on grounds other than those most artistically pleaded).

directly or indirectly induce the act or acts constituting the violation or cause of action.

This court has avoided explicit "resolution of the rather thorny controlling person-respondeat superior issue." *Rolf* v. *Blyth, Eastman Dillion & Co., supra,* 570 F.2d at 48 n.19. *SEC* v. *Management Dynamics, Inc.,* 515 F.2d 801, 812-13 (2d Cir. 1975), reasoned in the light of the legislative history, that the "controlling person" provision of Section 20(a) was not intended to supplant the application of agency principles in securities cases, and that it was enacted to expand rather than to restrict the scope of liability under the securities laws,[5] the court, however, intimated no view as to cases involving minor employees, claims for damages, or respondeat superior which might be broader than the apparent authority involved in *Management Dynamics,* which dealt with actions of a principal executive officer using corporate facilities to create a misleading appearance of activity in the stock in question. A little later in *SEC* v. *Geon Industries, Inc.,* 531 F.2d 39, 54-56 (2d Cir. 1976), the court, reiterating the view expressed in *Management Dynamics,* again rejected the theory that a brokerage firm

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[5] *Management Dynamics* discussed Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o, as well as Section 20(a). Section 15 originally made controlling persons liable under Securities Act Section 11 (imposing liability for untrue or misleading statements in a registration statement on issuer, underwriter and others involved with the registration statement) and Section 12 (imposing liability on sellers of unregistered securities or securities sold by means of untrue of misleading statements) jointly and severally with the controlled person to anyone to whom the controlled person was liable. The Act which enacted the '34 Act amended Section 15 of the '33 Act by adding at the end "unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."

called to account for an employee's activities could be liable only as a controlling person under § 20(a). The court, however, declined to enjoin the firm on the theory that as employer it was responsible for the acts of its employee, a registered representative, finding that the firm had exercised reasonable supervision over him, that he had made no special use of his connection with the firm, and that the firm derived only ordinary commissions from his activities. Judge Friendly stated for the court that, "we intimate no view as to cases with different facts, and that situations which fall between [*Management Dynamics*] and this one will have to await future resolution." 531 F.2d at 55-56. Nevertheless, as a footnote in *Woodward* v. *Metro Bank of Dallas,* 522 F.2d 84, 94 n.22 (5th Cir. 1975), illustrates, it has been thought that the Second Circuit has taken the view that Section 20(a) is the exclusive way to impose secondary liability.

The cases in this court are not, however, to that effect. *Moerman* v. *Zipco, Inc.,* 422 F.2d 871 (1970), affirming on the district court opinion, 302 F. Supp. 439 (E.D.N.Y. 1969), approved the imposition of liability on a corporation and its controlling directors under Section 20(a); but nothing in the district court opinion considered normal agency principles, or treated Section 20(a) as supplanting the doctrine of respondeat superior. The *en banc* decision in *Lanza* v. *Drexel & Co.,* 479 F.2d 1277, 1299 (2d Cir. 1973), declined to impose Rule 10b-5 liability, through Section 20(a), on an outside director of BarChris Corporation for fraud perpetrated by other officials of the corporation in inducing the plaintiffs to exchange stock in their thriving company for shares of BarChris stock that soon became worthless. The *Lanza* case did not present any occasion for

considering respondeat superior; only if the court had held that the director was in guilty complicity with the officials of the corporation who had perpetrated the fraud would the court have had to decide whether the investment banking firm of which the defendant director was an employee was liable on a respondeat superior or Section 20(a) theory for its employee's delinquency. 479 F.2d at 1319-20 (opinion of Judge Hays, dissenting in part). The district court in *Gordon* v. *Burr,* 366 F. Supp. 156, 167-168 (S.D.N.Y. 1973), adopted the view that Section 20(a) and not respondeat superior is the appropriate standard for determining secondary liability of a brokerage firm under the '34 Act, but this court, reversing the district court's imposition of Section 20(a) liability on a brokerage house by reason of the fraud of one of its stock salesmen did not comment on the rationale of the decision in the court below; it said only that if the brokerage house was liable it must be "derivatively—as a 'controlling person' of [the salesman] within the meaning of § 20(a) of the 1934 Act." *Gordon* v. *Burr,* 506 F.2d 1080, 1085 (2d Cir. 1974). The court cited *SEC* v. *Lum's Inc.,* 365 F. Supp. 1046, 1064-65 (S.D.N.Y. 1973), which rejected the respondeat superior approach, with evident approval, but the part of the *Lum's* opinion cited deals principally with the standard of culpability required for Section 20(a) liability, and that was the point on which this court cited it. Moreover this court has in *Management Dynamics, supra,* 515 F.2d at 813, stated that *Gordon* v. *Burr* does not dictate a result contrary to the application of agency principles to hold brokerage firms liable for acts of their employees; *Geon Industries, supra,* 531 F.2d at 54, states that this court has, in *Management Dynamics,* held the *Lum's* view—that a brokerage house could be liable for

its employee's securities frauds only as a controlling person under Section 20(a)—to be erroneous. In *Edwards & Hanly* v. *Wells Fargo Securities Clearance Corp.*, 458 F. Supp. 1110 (S.D.N.Y. 1978), the court held that a defendant was liable for its president's Rule 10b-5 frauds both on the respondeat superior and on the Section 20(a) theories, but the judgment was reversed because the evidence was insufficient to support a finding that the individual wrongdoer had aided and abetted the fraud in question and because the damage to the plaintiff was occasioned by its own failure to exercise due diligence in the supervision of the account in question and of its own compliance with applicable regulations. 602 F.2d at 485-89.

Cases in other circuits are not in agreement about the relation of respondeat superior to Section 20(a) liability. The Eighth Circuit, in *Myzel* v. *Fields*, 386 F.2d 718, 737-739 (8th Cir. 1967), imposed Section 20(a) liability in a Rule 10b-5 case in which, on the evidence, the liability of the allegedly controlling persons was governed "neither by principles of agency nor conspiracy," but the court assumed that common law principles of agency would apply to impose liability on a principal for an agent's deceit committed in the business he was appointed to carry out.

The Sixth Circuit, in *Armstrong, Jones & Co.* v. *SEC*, 421 F.2d 359, 362 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970), held, adopting the position of the Securities Exchange Commission, that sanctions may be imposed on a broker-dealer for the wilful violations of its agents under the doctrine of respondeat superior; the court did not refer to Section 20(a). In *Holloway* v. *Howerdd*, 536 F.2d 690, 694-95 (6th Cir. 1976), the Sixth Circuit, following what it took to be the lead of the Second, Fourth, Fifth, and Seventh

Circuits, went farther in holding that the controlling person provisions, Section 15 of the '33 Act and Section 20(a) of the '34 Act, were not intended to preempt the operation of the doctrine of respondeat superior in cases involving unlawful activities of a brokerage firm's employees. It imposed damage liability on the firm in favor of those customers of the firm who were ignorant of the limitations on the authority of the wrongdoing employee. The court relied on what had been said in *Management Dynamics, supra,* 515 F.2d at 812, to the effect that the controlling person provisions were intended to expand, rather than restrict, the scope of liability under the securities laws.

The Fourth Circuit, in *Johns Hopkins University* v. *Hutton,* 422 F.2d 1124 (4th Cir. 1970), *cert. denied,* 416 U.S. 916 (1974), a case brought under § 12(2) of the '33 Act, 15 U.S.C. § 771(2), held a brokerage house liable "under familiar [agency] principles, for the tortious representations of its agent"; although the partners of the defendant brokerage house were personally blameless, they had clothed their departmental manager with actual and apparent authority to provide the purchaser of the security with information about its yield, the manager acted within the scope of his employment in offering the security to the purchaser, and the firm received compensation based on the manager's sales effort. The court held that Section 15 of the '33 Act, 15 U.S.C. § 77o, which imposes a controlling person liability parallel to that imposed by Section 20(a) of the '34 Act, was not intended to insulate a brokerage house from the misdeeds of its employees.

The Fifth Circuit in *Lewis* v. *Walston & Co.,* 487 F.2d 617 (5th Cir. 1973), applied agency principles in imposing liability on a brokerage firm in a suit under Section 12(1)

of the '33 Act for an employee's sale of unregistered stock to plaintiffs, notwithstanding that the brokerage house never received a commission or other benefit from the transactions, did not deal in unregistered securities in the course of its own business, and did not perform any of its usual brokerage functions in the completion of the sales transactions. Later, in a case in which liability under Rule 10b-5 could have been imposed only under Section 20(a) if the evidence had warranted it, the Fifth Circuit, under the mistaken impression that *Gordon* v. *Burr, supra,* had committed this circuit to the view that Section 20(a) was "the exclusive way to hold someone secondarily liable" in Rule 10b-5 cases, stated that such an approach might be unnecessarily restrictive to the securities acts but that it did not need to resolve that question in the case before it. *Woodward* v. *Metro Bank of Dallas,* 522 F.2d 84, 94 n.22 (5th Cir. 1975). The Seventh Circuit in a "churning" case, *Fey* v. *Walston & Co.,* 493 F.2d 1036, 1052-53 (7th Cir. 1974), held a brokerage house liable for the conduct of one of its officers, on the ground that "the general law rendered the broker liable for any churning conduct by its representative, and foundation for this result need not be sought within the confines of Section 20(a)." *Id.* at 1052. The Tenth Circuit in *Richardson* v. *MacArthur,* 451 F.2d 35, 41-42 (10th Cir. 1971), imposed Section 20(a) liability or, an employing corporation in a Rule 10b-5 case, saying that, "Liability under § 20(a) is not restricted by principles of agency or conspiracy." *Id.* at 41. The court did not make a respondeat superior analysis of the facts.

The earliest of the cases usually cited for the proposition that Section 20(a) of the '34 Act supplanted the doctrine of respondeat superior in securities cases, *Kamen & Co.* v.

Paul H. Aschkar & Co., 382 F.2d 689, 697 (9th Cir. 1967), does not elaborate the point, and *Hecht* v. *Harris, Upham & Co.*, 403 F.2d 1202, 1210 (9th Cir. 1970), which imposed liability in a churning case, did so under Section 20(a) on the basis that the brokerage house had failed to maintain adequate internal controls, and that its failure of diligence constituted failure to act in good faith; the court did not refer to the doctrine of respondeat superior. Later, in *Zweig* v. *Hearst Corp.*, 521 F.2d 1129, 1132-33 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975), the court interpreted its earlier decision in *Kamen* as holding that Section 20(a) is to be applied to determine an employing corporation's liability and as rejecting the contention that "the more stringent doctrine of *respondeat superior* remained effective to establish vicarious liability." The court did not explain the basis for its conclusion. Most recently, in *Christoffel* v. *E.F. Hutton & Co.*, 588 F.2d 665, 667 (9th Cir. 1978), the court, in a single sentence, and, again, without discussion, stated that it was "the established law of [the 9th] Circuit that section 20(a) supplants vicarious liability of an employer for the acts of an employee applying the respondeat superior doctrine."

The Third Circuit, in *Rochez Brothers, Inc.* v. *Rhoades*, 527 F.2d 880, 884-886 (3rd Cir. 1975), concluded in what is, it may be, elaborate dictum, that, in the light of the legislative history and of earlier cases, "the principles of agency, i.e., *respondeat superior*, are inappropriate to impose secondary liability in a securities violation case". *Id.* at 884. The court put its conclusion essentially on the ground that the defense furnished by the closing language of Section 20(a)—

> . . . unless the controlling person acted in good faith and did not directly or indirectly induce the

act or acts constituting the violation or cause of action—

established a standard of conscious culpability that was inconsistent with the imposition of an essentially secondary liability on respondeat superior grounds.[6] *Rochez Brothers* was followed in *Thomas* v. *Duralite Co.*, 524 F.2d 577, 586 (3rd Cir. 1975). In both cases liability was not in fact imposed under Section 20(a) because, in *Rochez Brothers,* the active wrongdoer, and not the corporation of which he was an officer, was the controlling person, and because, in *Duralite,* the active wrongdoers were not acting for the corporation in the transaction in the corporation's shares.[7]

(c) While the precise standard of supervision required of broker-dealers to make good the good faith defense of Section 20(a) is uncertain, where, as in the present case, the erring salesman completes the transactions through the employing brokerage house and the brokerage house re-

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[6] Before turning to the question of the appropriate standards of secondary liability the court seems to have decided, in agreement with the district court's factual finding, that a traditional agency analysis would not have resulted in a judgment against the wrong-doing individual's corporate employer; the wrongdoing employee was president, a director, and a 50% stockholder of the employing corporation, and he bought 50% of the corporation's stock from the corporation's executive vice-president without disclosing that there were in the wind two possible buyers for all the company's stock. 527 F.2d at 883-84.

[7] *Rochez Brothers* noted that the relationship before it was not of the type that prevails in the broker-dealer cases where a stringent duty to supervise employees exists. 527 F.2d at 886. *Duralite* indicated that whatever the merit of imposing respondeat superior liability in a broker-agent relationship, the circumstances in the *Duralite* case were different and required a different result. For references to the effect of the presence of a fiduciary relationship, *see Edwards & Hanly* v. *Wells Fargo Securities Clearance Corp., supra,* 602 F.2d at 485; *Rolf* v. *Blyth, Eastman Dillon & Co., supra,* 570 F.2d at 47.

ceives a commission on the transactions, the burden of proving good faith if shifted to the brokerage house, *Stern* v. *American Bankshares Corp.*, 429 F. Supp. 818, 823 (E.D. Wis. 1977), and requires it to show at least that it has not been negligent in supervision, *SEC* v. *Geon Industries, Inc., supra,* 531 F.2d at 54; *Gordon* v. *Burr, supra,* 506 F.2d at 1085-86; *SEC* v. *Lum's Inc., supra,* 365 F. Supp. at 1064-65, and that it has maintained and enforced a reasonable and proper system of supervision and internal control over sales personnel. *Zweig* v. *Hearst, supra,* 521 F.2d at 1134-35. That Wood, Walker has successfully met the charge that it aided and abetted Kohn does not establish that it has borne the burden of proving "good faith" under the last clause of Section 20(a). The intimation of Judge Gagliardi's findings of fact is to the contrary; he was very far from finding that Wood, Walker had shown due care in its supervision and control of Kohn's activities.

Different considerations control the application of respondeat superior principles. Here the concern is simply with scope or course of employment and whether the acts of the employee Kohn can fairly be considered to be within the scope of his employment. *See* Restatement (Second) of Agency §§ 228, 229, 257, 258, 261, 262, 265. The evidence of record in the present case presents substantial issues of credibility and interpretation, but it indicates, if taken at face value, that Kohn at all times acted as an employee of Wood, Walker, and accounted to Wood, Walker for the transactions. The evidence contains no indication that he profited by any of the transactions other than by reason of his compensation from Wood, Walker as one of its employees. Whatever the specific limitations on his authority as between his and his employer, the evidence, again, indi-

cates, although with some uncertainty, that it was his function as a trainee to be an intermediary in the making of transactions in securities, but that there were certain limitations on the manner in which he was to carry on his activities. Kohn's deviant conduct, while it may have induced the purchase of securities that would not otherwise have been purchased, did not appear, on the record made at the trial, to mark any deviation from Kohn's services to his employer. Arguably, what he did was done in Wood, Walker's service, though it was done badly and contrary to the practices of the industry and the standing instructions of the firm. The record on the respondeat superior issue more than sufficed to require the trier of the fact to dispose of the issue on the merits.

Where respondeat superior principles are applied, the special good faith defense afforded by the last clause of Section 20(a) is unavailable. Quite apart from the fact that that conclusion was clearly adumbrated in *SEC* v. *Management Dynamics, supra,* 515 F.2d at 812-13, and has become settled law in other circuits, there is no warrant for believing that Section 20(a) was intended to narrow the remedies of the customers of brokerage houses or to create a novel defense in cases otherwise governed by traditional agency principles. On the contrary, Section 28(a), 15 U.S.C. § 78bb, specifically enacts that the rights and remedies provided by the '34 Act shall be in addition to any and all rights and remedies that may exist at law or in equity, and Section 16 of the '33 Act, 15 U.S.C. § 77p, similarly provides that the rights and remedies of the '33 Act are additional to pre-existing remedies.

The judgment against defendant Kohn is affirmed and the judgment in favor of Wood, Walker & Co. is reversed,

and a new trial of the claims of Marbury Management and Harry Bader against Wood, Walker & Co. is granted.

[*Dissenting Opinion*]

MESKILL, J., dissenting: In straining to reach a sympathetic result, the majority overlooks a fundamental principle of causation which has long prevailed under the common law of fraud and which had been applied to comparable claims brought under the federal securities acts. This is, quite simply, that the injury averred must proceed directly from the wrong alleged and must not be attributable to some supervening cause. This elementary rule precludes recovery in the case at bar since Kohn's misrepresentations as to his qualifications as a broker in no way caused the decline in the market value of the stocks he promoted.

I share my colleagues' condemnation of Kohn's misconduct and express no view as to whether recourse may lie in an appropriate court under a theory more feasible than the one advanced by plaintiffs. In approving Kohn's present sanction, however, the majority is more righteous than right, for its decision abandons the traditional understanding of causation in the context of the sale of securities induced through misrepresentation, disregards governing precedent and extends the reach of Section 10(b) beyond that of its common law antecedent to provide for recovery in cases in which federal policies are offened by such expansion. Accordingly, I respectfully dissent.

The essential facts are undisputed and bear but brief recapitulation. While a trainee at the brokerage firm of Wood, Walker & Co., Kohn deceitfully held himself out to be a registered representative and "portfolio management specialist." Trading upon those non-existent creden-

tials,[1] he persuaded Marbury Management and its principal shareholder, Bader, to purchase several highly speculative stocks. Contrary to a New York Stock Exchange rule requiring that purchase orders placed by novices be reviewed and approved by licensed brokers, Wood, Walker processed these orders without the necessary clearance. Despite Kohn's sincere belief in the bright prospects of each of these investments, their market value plummeted. The precise timing of their decline and the reasons therefor are not apparent from the record; it suffices for present purposes to note that Kohn's exaggeration of his expertise played no role in the economic collapse of the various stocks he had touted.

Under these circumstances, no recovery may be had against either Kohn or Wood, Walker under Section 10(b) since it is patent that the essential element of causation was not and could not be established as a matter of law. While it is true that Kohn's misrepresentations may have been a precondition of the ensuing injury in that the investments might not have been made had he revealed his lack of qualifications, those misstatements nevertheless do not constitute the legal cause of the subsequent pecuniary loss and consequently will not suffice to establish an actionable fraud.[2]

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[1] Plaintiffs also averred that Kohn falsely represented to them that he based his investment advice on "inside information." As to these claims, the trial court found, and it is not disputed here, that the statements were merely nonactionable projections.

[2] Since the injury in the instant case derived from the unanticipated decline in the market value of the stocks Kohn had promoted, the situation is distinguishable from that presented in *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811 (2d Cir. 1975). There, plaintiff mutual fund alleged that it had been defrauded by an investment advisory firm which after obtaining

From time immemorial proof of proximate cause—the legal link between the misconduct alleged and the injury averred—has been a precondition of recovery under theories of fraud and deceit. It is axiomatic that fraudulent misrepresentations are not actionable where the subsequent injury is due to an intervening or supervening cause. As applied to the sale of stock precipitated by misstatements, these principles of causation are satisfied only where the misrepresentation touches upon the reasons for the investment's decline in value. Thus, where one is induced to purchase securities in reliance upon a claim which, however deceitful, is immaterial to the operative reason for the pecuniary loss, recovery under a theory of fraud is precluded by the inability to prove the requisite causation.[3] *See, e.g., Hotaling* v. *A. B. Leach & Co.*, 247 N.Y. 84,

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the fund's business deliberately proceeded to loot the assets placed under its supervision through unlawful investment. The mutual fund thereafter sued the independent auditors who had certified the advisor's extremely favorable, but false, financial statement, alleging that the misimpression gained from that document led the fund to retain the larcenous advisor.

In contrast to the instant case, *Competitive Associates,* in which we reversed a summary judgment in favor of the defendants, involved an alleged scheme which provided a direct connection between the wrong and the injury, uninterrupted by any intervening independent cause. Thus, in that case a fraudulent scheme to pilfer the mutual fund was already afoot at the time of the violation, and the plaintiff's losses were inevitable upon the advisor's procurement of the account. The case at bar involves no such scheme, and plaintiffs' losses were certainly not intended by Kohn at the time he gained their account.

3 Under the securities statutes, liability is limited, by principles of causation even where the plaintiff is aided by a presumption in his favor. For example, under Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, which proscribes false or misleading representations in registration statements, a plaintiff may recover the difference between the purchase price of a security and its market value at the time of the filing of his suit, without having to establish a causal connection between the false statement and the decline of the stock.

87 (1928) ("The plaintiff should be entitled to recover from the defendants the loss which is the proximate result of the fraud that induced the investment; the defendants should not be held liable for any part of plaintiff's loss caused by subsequent events not connected with such fraud."); *Abel* v. *Paterno,* 245 App. Div. 285, 281 N.Y.S. 58 (1st Dept. 1935); *People* v. *S. W. Straus & Co.,* 156 Misc. 642, 282 N.Y.S. 972 (Sup. Ct. Kings Cty. 1935).[4] Prosser categorically states:

> . . . if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline of the market, or insolvency of the corporation, brought about by business conditions or other factors in no way related to the representations, will not afford any basis for recovery. It is only where the fact misstated was of a nature calculated to bring about such a result that damages for it can be recovered.

Prosser, *Law of Torts,* ¶ 110 at 732 (4th ed.) (footnotes omitted).

However, the courts have permitted a reduction in damages to the extent that defendants can prove that the loss of value is due to reasons unrelated to the matters misrepresented in the registration statement. *See Feit* v. *Leasco Data Processing Equipment Corp.,* 332 F.Supp. 544, 584-88 (E.D.N.Y. 1971), *and see* footnote 7, *infra.*

[4] I respectfully suggest that the authorities cited by the majority in support of its broad notion of causality in fraud cases involving the sale of stock, many of them decided before the current federal securities laws were enacted and many involving the sale of tangibles, do not conflict with the more restrictive standard suggested here. For example, in *Hotaling* v. *A.B. Leach & Co.,* 247 N.Y. 84 (1928), Judge Lehman permitted recovery, but specifically noted, "The loss sustained is directly traceable to the original misrepresentation of the character of the investment the plaintiff was induced to make." *Id.* at 93.

The rationale for this exacting standard of causation is quite simply that one should be held liable only for the foreseeable consequences of one's action. Where the purcase of stock is induced through a misrepresentation, one is chargeable only for the consequences flowing from that statement; one does not thereby become an insurer of the investment, responsible for an indefinite period of time for any and all manner of unforeseen difficulties which may eventually beset the stock. This Court has previously remarked upon the necessity of thus restricting "the potentially limitless thrust of Rule 10b-5 to those situations in which there exists a causation in fact between the act and injury." *Titan Group, Inc.* v. *Faggen,* 513 F.2d 234, 239 (2d Cir.), *cert. denied,* 423 U.S. 840 (1975). *See also Globus* v. *Law Research Service, Inc.,* 418 F.2d 1276, 1292 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970) ("causation must be proved else defendants could be held liable to all the world"); *List* v. *Fashion Park, Inc.,* 340 F.2d 457, 463 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965) (Rule 10b-5 does not "establish a scheme of investors' insurance"). The Restatement (2d) of Torts takes a similar view. Discussing the situation in which the financial condition of a company has been misrepresented to the purchaser of stock the authors conclude:

> there is no liability when the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition. There is, for example, no liability when the shares go down because of the sudden death of the corporation's leading officers. Although the misrepresentation has

> in fact caused the loss, since it has induced the purchase without which the loss would not have occurred, it is not a legal cause of the loss for which the maker is responsible.

Restatement (2d) of Torts § 548A at 107 (1977).[5]

Although the term causation is not itself used in Section 10(b) or Rule 10b-5, it has never been doubted that it is an essential element of a claim brought thereunder. This belief is based on the statute's common law ancestry upon Section 28a of the Securities Exchange Act, 15 U.S.C. § 78bb, which limits recoveries to "actual damages on account of the act complained of," and upon case law, most notably *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 153-54 (1972), which recognized "the requisite element

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[5] The proposed ALI Federal Securities Code takes the same approach to the question of causation:

> when the market declines after the published rectification of a false earnings statement that was used in the sale of an electronics stock, the misrepresentation is not the "legal cause" of the buyer's loss, or at any rate not the *sole* legal cause, to the extent that a subsequent event that had no connection with or relation to the misrepresentation occurred—for example, the sudden death of the corporation's president or a softening of the market in all electronics stocks. *See Feit* v. *Leasco Data Processing Equipment Corp.*, 332 F.Supp. 544, 586-88 (E.D.N.Y. 1971), 47 Ind. L.J. 367 (1972). . . .
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> [ ]That is to say, the basic distinction between reliance and *legal* cause bears emphasizing, because the two concepts are so frequently blurred: A buyer can have *relied* on a seller's misstatement of a material fact in deciding to buy; but, if the general market drops precipitately the next day on news of a political assassination or an invasion in some part of the world, the buyer's loss is caused not by the misstatement (except in the "but for" or *post hoc propter hoc* sense) but by the disastrous political news.

Tentative Draft #2, § 215A at 5 (1973). (Commentary on § 220 of the Proposed Official Draft (1978)).

of causation in fact," and *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971), wherein reference is made to the requirement that the defrauded party must suffer an injury as a result of the deceptive practice. *See also Titan Group, Inc.* v. *Faggen, supra,* 513 F.2d at 239 ("causation remains a necessary element in a private action for damages under Rule 10b-5."); *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 238 (2d Cir. 1974) ("We have consistently held that causation is a necessary element of a private action for damages under Rule 10b-5."); *compare Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970) ("the test is properly one of tort 'causation in fact' ") with *Globus* v. *Law Research Service, Inc., supra,* 418 F.2d at 1291-92 ("there was sufficient evidence to support a finding of causal relationship between the misrepresentation and the losses appellees incurred when they sold.").

Mere factual causation however is not enough. Causation in cases under the securities acts is governed by the principle, set forth above, that the loss complained of must proceed *directly* and proximately from the violation claimed and not be attributable to some supervening cause. *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1, 51 (1977) (Blackmun, J., concurring). While this rule is easily stated, its application to cases brought under the federal statutes has frequently been problematic since in such cases both the violation and the resulting loss must each be linked with the requirement of a securities transaction, whether it be a purchase or sale as would be the case in an action under Section 10(b), or the exercise of the shareholder's franchise, as would be the case in an action under Section 14.

That is, the violation must have precipitated the securities decision (be it a purchase or sale or a shareholder's vote), a requirement denominated as "transaction causation," and the victim's injury must also be proven to have derived from that same securities decision, a requirement somewhat ambiguously termed "loss causation," *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).[6] Attempts to prove the existence of each link in this somewhat elongated chain of causation have engendered considerable controversy. With respect to "transaction causation," it was frequently contended, particularly in nondisclosure cases, that plaintiff's coarse of action was in fact unaffected by the material omissions, and this first link had not, therefore, been established. Such contentions have been rejected in several cases, *see Mills* v. *Electric Auto-Lite Co.*,

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[6] "Loss causation," as the term is used in *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-82 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975), may mean nothing more than the proposition advanced here, that the injury must be proximately used by the precise violation alleged. Thus, the Court noted that in order to recover in cases charging fraudulent misrepresentation or omissions,

> [T]here would have to be a showing of both *loss causation*—that the misrepresentations or omissions caused the economic harm—and *transaction causation*—that the violation in question caused the appellant to engage in the transaction in question.

507 F.2d at 380 (emphasis in original; footnote omitted). However, most commentators have construed this term to connote the necessary causal nexus between the securities transaction and the injury, rather than the requisite connection between the violation and the injury. *See, e.g.*, Jennings & Marsh, *Securities Regulation* at 1068-69 (4th ed. 1977). Judge Frankel, concurring in the result in *Schlick*, expressed reluctance about the phrase coined, *see* 507 F.2d at 384, and other courts have been noticeably reluctant expressly to adopt this language. *See, e.g., Moody* v. *Bache & Co., Inc.* 570 F.2d 523, 527 n.7 (5th Cir. 1978); *St. Louis Union Trust Co.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048 n.11 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978).

396 U.S. 375, 385 (1970), and *Affiliated Ute Citizens* v. *United States, supra,* 406 U.S. at 153-54; *see also Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra,* 495 F.2d at 238-40, which hold that in nondisclosure suits, transaction causation will be presumed when the matters withheld are material. *See Piper* v. *Chris-Craft Industries, Inc., supra,* 430 U.S. at 50-51 (1977) (Blackmun, J., concurring). Similarly spirited defenses have also been raised with respect to the second link, as defendants have claimed that the injury was not occasioned by a securities transaction, or that the connection between those events was too attenuated to satitsfy the loss causation requirement. *See Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6 (1971); *Vine* v. *Beneficial Finance Co.,* 374 F.2d 627 (2d Cir.), *cert. denied,* 389 U.S. 970 (1967); *Hoover* v. *Allen,* 241 F.Supp. 213, 230 (S.D.N.Y. 1965). *See also Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.,* 480 F.2d 341, 401 (2d Cir. 1973) (Mansfield, J., concurring and dissenting).

In my view, these cases do not undercut the requirement that a single direct causal chain run uninterrupted from the alleged violation through a securities transaction to a demonstrable injury. In resolving the technical problems of establishing transaction or loss causation, the courts have refused to create insuperable barriers to the demonstration of their existence, and in appropriate situations have allowed the element of causation to be demonstrated through resort to related notions such as reliance or materiality. Nevertheless, in facilitating the proof of causation, the courts have never renonuced the element itself, and have never departed from the rudimentary principle that causation will not be found to exist where there is lacking a single, logical procession from the violation to the injury.

On the contrary, the courts have consistently denied recovery of damages in situations, such as the present case, where the effect of the misrepresentation is merely to place a victim in a vulnerable position which subsequently leads to his injury due to a supervening event. For example, in *Oleck* v. *Fischer,* CCH [1979 Transfer Binder] FED. SEC. L. REP. ¶ 96,898 (S.D.N.Y. 1979), appeal argued, No. 79-7513 (2d Cir. Feb. 7, 1980), plaintiffs after reading defendant's prospectus sold them their business in exchange for promissory notes payable over time. The prospectus projected a favorable image of defendant's financial condition, due in part to a misrepresentation of the collectibility of a substantial debt owed defendant by a third party. That obligation was in fact defauted upon, defendant underwent a financial collapse, and plaintiff never received payment on its notes. The district court denied relief against the defendant or its independent accountant, however, since it held that the misrepresentation was not the operative cause for defendant's demise and plaintiff's consequent losses, which were in fact due to defendant's catastrophic losses in certain coal mining ventures which could not have been offset even if the debt had been fully discharged. Consequently, recovery was denied, *inter alia,* on the grounds that causation had not been established.

Again, in *Miller* v. *Schweickart,* 413 F.Supp. 1062 (S.D. N.Y. 1976), a brokerage firm for serveral years engaged in an allegedly illicit arrangement with the Skelly Oil Company involving the sale and repurchase of bonds. Two years after this relationship had ceased, the brokerage firm went bankrupt, and its limited partners, who had allegedly invested due to the favorable financial picture made possible by the bond dealings, brought an action under the securities acts against the firm's general partners and Skelly. Finding

that the brokerage firm's financial collapse was due to developments other than the consequences of the sale-repurchase agreement, Judge Weinfeld granted Skelly's motion for summary judgment stating:

> To accept plaintiffs' theory would extend liability for fraud beyond the immediate and foreseeable consequences of one's wrongdoing and in effect make Skelly the permanent accomplice of the Schweickart general partners in all their subsequent parking transactions with others; it would subject Skelly to strict liability for any future depredations by those general partners long after Skelly had ceased to have any dealings with Schweickart, even for deeds done with others years later, of which Skelly had no knowledge. This is causation run riot.

413 F.Supp. at 1068.[7]

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[7] The standard of causation espoused here is also implicit in the manner of calculating damages in cases successfully prosecuted under Section 10(b). Generally, plaintiffs will be awarded the difference between their purchase price and sale price, with an adjustment for that portion of their loss which is attributable to factors other than those concealed or misrepresented such as a general market decline. *Rolf* v. *Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 48-50 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). *But see Clark* v. *John Lamula Investors, Inc.*, 583 F.2d 594, 603-04 (2d Cir. 1978). *See also Bonime* v. *Doyle*, 416 F.Supp. 1372 (S.D.N.Y. 1976), aff'd. 556 F.2d 554 (2d Cir. 1977), where the district court approved the settlement of a class action securities fraud suit over objection that the recovery was too meager, noting that while the stock purchases may have been fraudulently induced, the damages might in large measure have been attributable to other causes unrelated to the alleged misstatements. In rejecting a more lucrative method of computing damages. Judge Lasker stated:

> It therefore has the potential of creating a windfall recovery to a plaintiff in the nature of indemnification against the risks of the vicissitudes of the market, and at the same time saddling defendants with payments far out of proportion to the damages caused by their fraud.

This fundamental principle of causation is equally well illustrated in the context of cases arising under Section 14. In *Mills* v. *Electric Auto-Lite Co., supra,* the Supreme Court held that where proxies are obtained through the use of misleading solicitations, a damage action under Section 14 will lie to recover for harms later visited upon the corporations only if that resulting injury flowed from the corporate action for which shareholder approval had been sought:

> Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself . . . was an essential link in the accomplishment of the transaction.

Id. 396 U.S. at 385.[8]

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416 F.Supp. at 1384. *See also Federman* v. *Empire Fire and Marine Ins. Co.,* CCH [1975-76 Transfer Binder] ¶ 95,418 (S.D.N.Y. 1976), *rev'd in part on other grounds,* 597 F.2d 798 (2d Cir. 1979).

[8] In *Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375 (1970), shareholders of Auto-Lite alleged that the corporation's directors had violated Section 14 by soliciting proxies for approval of a merger with Mergenthaler Linotype Co. without disclosing in the proxy materials that they were nominees of Mergenthaler. The Court held *inter alia* that there was no need to demonstrate a connection between the precise misstatement and the ultimate harm, that is, there was no need to establish that the allegedly unfair merger terms were arrived at because of the split allegiance of the directors. Plaintiffs were required to demonstrate only that the shareholders' acquiescence in the plan had been unlawfully obtained:

> a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.

396 U.S. at 385. This rule does not mandate a relaxation in the standard of causation suggested here since the violation in *Mills* lay not in the directors' advising approval of the merger, but in the procurement of shareholder acceptance of the plan through a failure to reveal that their ostensibly loyal directors who were recommending the proposal, were in fact corporate double agents.

Where the misleading proxy solicitation is merely a first step which ultimately results in losses from an unrelated or supervening cause, relief cannot be obtained under Section 14. *Weisberg* v. *Coastal States Gas Corp.*, 609 F.2d 650, 654 (2d Cir. 1979), *petition for cert. filed*, 48 U.S.L.W. 3619 (U.S. Feb. 5, 1980); *Maldonado* v. *Flynn*, 597 F.2d 789, 795-96 (2d Cir. 1979); *see also Galef* v. *Alevander*, slip op. 5893, 5924-25 (2d Cir. Jan. 22, 1980). For example, if corporate officers are elected through solicitations which failed to disclose a material lack of qualifications, and those improperly elected officers subsequently proceed to harm the corporation and its shareholders through acts of deceit, waste or mismanagement which were not themselves authorized by the proxies, a suit to permit recovery of resultant damages will not be permitted. *See, e.g., Limmer* v. *General Telephone and Electronics Corp.*, CCH [1977-78 Transfer Binder] FED. SEC. L. REP. ¶ 96,111 (S.D.N.Y. 1977); *Levy* v. *Johnson*, CCH [1976-77 Transfer Binder] FED. SEC. L. REP. ¶ 95,899 (S.D.N.Y. 1977).[9]

Essentially the same situation is presented by the case at bar. But for Kohn's misrepresentation of his expertise, plaintiffs might not have purchased the ill-fated stocks which he touted. Like the improper election of incompetent or larcenous officers, his misconduct was a precondition of the eventual loss. But since the actual damage in both cases stemmed from supervening events unrelated to the mis-

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[9] *See also, Rediker* v. *Geon Industries, Inc.*, 464 F.Supp. 73, 82 (S.D.N.Y. 1978); *Kerrigan* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 450 F.Supp. 639, 643 (S.D.N.Y. 1978); *Maldonado* v. *Flynn*, 448 F.Supp. 1032, 1040 (S.D.N.Y. 1978), *aff'd in pertinent part*, 597 F.2d 789 (2d Cir. 1979); *Morgan* v. *Prudential Funds, Inc.*, 446 F.Supp. 628, 633 (S.D.N.Y. 1978); *Goldberger* v. *Baker*, 442 F.Supp. 659, 666 (S.D.N.Y. 1977).

statements that induced the transactions, the chain of causation has been broken and recovery may not be had.

It might only be added that there seems to be no policy justification for the refusal to give effect to the traditional standard of causation. The mission of Section 10(b) is to give persons dealing in securities equal access to information so that informed investment decisions may be made. *J.I. Case Co.* v. *Borak,* 377 U.S. 426 (1964). It is debatable whether today's decision will further that goal since Kohn's dereliction was not in withholding or misstating data material to the merits of the investments he recommended, but only as to his expertise in promoting them.

On the other hand, repudiation of the traditional standard of causation will effectively thwart the oft-repeated goal of confining claims of corporate waste and mismanagement to the state courts which have the principal, if not exclusive, responsibility for such matters. *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 479 (1977); *Cort* v. *Ash,* 422 U.S. 66, 84 (1975); *Superintendent of Insurance* v. *Bankers Life & Casualty Co., supra,* 404 U.S. at 12 ("Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.") Under the causation test promulgated today the federal courts will be obliged to entertain suits brought by parties claiming to have been fraudulently induced to purchase stock which subsequently declined in value due to ineptitude, poor judgment or neglect. These are precisely the types of cases which this Court has refused to entertain, and yet, today's holding will open a back door to the federal courthouse for these same cases which have historically been left to state adjudication.

The majority offers no compelling rationale for its refusal to abide by the acknowledged standard of causation. It is emphasized that the misrepresentation in issue not only prompted the initial purchase but was later repeated so as to cause the retention of the stocks. This observation has no bearing on the principle governing this action. First, the trial judge did not make such a factual finding, and I do not believe that it can be "implied" from the opinion below. Factual support for such an approach appears to be lacking, since it may have been that Kohn's stocks all went into an immediate tailspin after their purchase by plaintiffs, and that they simply remained in this sorry state, or perhaps even revived somewhat, following Kohn's subsequent misrepresentations.[10] More significantly, this claim even if supported by the record would not supply the missing element of causation. The fact that the defrauded parties retained their stock after a reprise of Kohn's deception is no more the cause of the stock's loss of value than was Kohn's initial misrepresentation.

Because I view the causation issue as dispositive I would not consider whether it is permissible or advisable for this Court to formulate on plaintiffs' behalf theories of Wood, Walker's liability which were not averred in the pleadings, actively litigated or resolved by the trial court, *see* Opinion of the District Court at 17 n.11. Consequently, I intimate no view on the merits of those issues.

The judgment as to Wood, Walker should be affirmed and as to Kohn, reversed.

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[10] The only testimony on the subject concerns the stock prices on the date of purchase, the date of Kohn's unmasking and the date of sale.

APPENDIX B

Decision of the United States District Court for the Southern District of New York

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

No. 72 Civ. 5121

April 25, 1979.

MARBURY MANAGEMENT, INC.,
HARRY BADER AND HARVEY JAFFE,

Plaintiffs,

v.

ALFRED KOHN AND WOOD, WALKER & CO.,

Defendants.

George Berkowitz, New York City, for plaintiffs.

Lunney, Downey & Crocco, New York City, for defendant Wood, Walker & Co.; Charles A. Crocco, Jr., New York City, of counsel.

Fisher & Klein, New York City, for defendant Kohn; Jay D. Fisher, New York City, of counsel.

OPINION

GAGLIARDI, District Judge.

Plaintiffs Marbury Management, Inc., Harry Bader and Harvey Jaffe commenced this action against the brokerage

firm of Wood, Walker & Co. ("Wood Walker") and its employee, Alfred Kohn, alleging violations of Section 10(b) of the Secuirties Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q, and common law fraud.[1] Jurisdiction is predicated upon 15 U.S.C. §§ 78aa, 77v and principles of pendent jurisdiction. This action was tried to the court and, at the conclusion of the evidence, the court granted Wood Walker's motion to dismiss the complaint on the ground that plaintiffs failed to prove a prima facie case against it (Tr. 188-90). The court reserved decision as to defendant Kohn's motion to dismiss the complaint against him.

Plaintiffs are former customers of defendant Wood Walker, a stock brokerage firm.[2] The complaint alleges that, beginning during the summer of 1967, Alfred Kohn falsely held himself out to be a licensed registered representative employed by Wood Walker. Plaintiffs claim that they placed buy and sell orders with Wood Walker through Kohn[3] in reliance upon his training and expertise. (Complaint, at ¶¶ 10, 37, 64). The complaint further alleges that Kohn offered advice to the plaintiffs regarding the investment potential of certain securities; that he represented that his opinion was "based upon personal conversations

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[1] This court dismsised the complaint against a third defendant, the New York Stock Exchange, Inc. in a memorandum decision dated January 24, 1974.

[2] Plaintiff Marbury Management is engaged in business as a finance company.

[3] A list of the securities that each of the plaintiffs purchased with Wood Walker through its employee, Alfred Kohn, is set forth in Schedules A, B, and C which are attached to the complaint. *See* n.14 for lists of the securities purchased by Marbury Management and Bader.

and meetings with officers and other persons who had unique information as to the transactions of the corporation and their effect on the market price"; and that Kohn knew that his representations were false when he made them but offered them in order to induce the plaintiffs to purchase certain stocks. (*Id.* ¶¶ 18-20, 42-45, 70-73). Wood Walker, it is alleged, permitted Kohn to hold himself out as a registered representative when it either knew or should have known that he was not so licensed. (*Id.* at ¶¶ 12-13, 39-40, 66-67). Based upon the aforesaid actions of the defendants, the complaint alleges three causes of action on behalf of each of the plaintiffs: violations of Section 10(b) of the Exchange Act (and Rule 10(b)(5) thereunder), Section 17(a) of the Securities Act of 1933, and fraud under the law of New York. The following constitutes this court's findings of fact and conclusions of law in accordance with Rule 52(a), Fed.R.Civ.P. Plaintiffs Marbury Management and Bader have proved their claims under § 10(b) and therefore are entitled to recover damages from Kohn. Plaintiff, Jaffe, however, has not proved all of the requisite elements of a § 10(b) cause of action and therefore is not entitled to relief. Plaintiff's motion for reconsideration of the court's dismissal of the complaint against Wood Walker pursuant to Rule 60(b), Fed.R.Civ.P. is also denied.

Discussion

1. *10(b) Claims Against Defendant Kohn*

[1] It is well established that an implied cause of action under § 10(b) will lie only if the plaintiffs can prove that the defendant willfully misstated or omitted a material fact which caused the plaintiff injury in connection with his purchase or sale of a security. *Ernst & Ernst* v. *Hochfelder,*

425 U.S. 185, 197, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976) (knowing or intentional conduct required); *TSC Industries Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976) (misstatement or omission must be material); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972); *Titan Group Inc.* v. *Faggen*, 513 F.2d 234, 237 (2d Cir. 1975) (causation still a necessary element in some private 10(b) actions); *Blue Chip Stamp* v. *Manor Drug Stores*, 421 U.S. 723, 730-31, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975) (plaintiff must be a purchaser or seller of securities).

[2-4] The complaint in this case alleges that Kohn made two types of misstatements giving rise to a private cause of action under § 10(b): (1) numerous prediction concerning the future earning capacities and proposed acquisitions of various companies, and (2) representations that he was a "portfolio management specialist." As to the first set of alleged misstatements, plaintiffs claim that Kohn stated that "he had a relative on the board of directors . . . of [DWG] corporation" and that the stock "should go up in price" (Gold Tr. 30) (Jaffe Tr. 90); that investors in Commuter Airlines Co. were likely to earn a "big return" (Bader Tr. 1) (Jaffe Tr. 100); that Capital Holding and Stanrock Uranium were "good stocks" which should return a profit (Bader Tr. 63-64); and that a favorable newspaper article regarding the Responsive Environment Co. would soon be published (Gold Tr. 33) (Bader Tr. 62). Although the plaintiffs claim that Kohn knew that these representations were false when he made them (Complaint ¶¶ 20, 47, 74), nothing in the record supports this conclusion. On the contrary, Robert Gold, President of plaintiff Marbury Management, testified that he did not believe that Kohn was making

fraudulent statements (Tr. 31, 41), and plaintiff Jaffe conceded that certain information and investment advice that Kohn gave to him may have been true (Tr. 116). Nor does the mere fact that the defendant's predictions did not materialize indicate that the statements were untrue at the time of issuance. *See A. Jacobs,* What is Misleading Statement or Omission under Rule 10b-5, 42 *Fordham L.Rev.* 243, 284 (1973) *citing inter alia Dolgow* v. *Anderson,* 53 F.R.D. 664, 670, 676-79 (E.D.N.Y. 1971) (intervening cause); *Milberg* v. *Western Pac. RR.,* 51 F.R.D. 280, 282 (S.D.N.Y. 1970) (cannot reasonably expect projections to be infallible in all situations). A false prediction, however, may be actionable if the plaintiff establishes that the statements, whether characterized as either fact or opinion,[4] were not prepared in a reasonable manner or with a firm

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[4] The fact-opinion dichotomy has become largely a distinction without a difference. Recommendations to buy or sell securities, opinions or estimates as to the present or the future status of an event, projections and predictions of future occurrences, and representations that an incident will take place all have been considered to be "facts" within the ambit of § 10(b). *See A. Jacobs, supra* at 279 *citing inter alia Chris Craft Indus., Inc.* v. *Bangor Punta Corp.,* 426 F.2d 569, 579 (2d Cir. 1970) (Lumbard, J. concurring) (the Rule covers "information" that dose not fit easily into categories of either "fact" or "opinion"); *Myzel* v. *Fields,* 386 F.2d 718, 734 n. 8 (9th Cir. 1967); *SEC* v. *American Plan Inv. Corp.,* [1972-1973 Transfer Binder] CCH Fed.Sec.L.Rep. ¶ 93,769, at 93,361 (C.D.Cal.1972) (consent order enjoining misleading projections); *Dolgow* v. *Anderson,* 53 F.R.D. 664, 670-79 (E.D.N.Y. 1971); *Sprayregen* v. *Livingston Oil Co.,* 295 F.Supp. 1376, 1377-78 (S.D.N.Y. 1968) (false statements on projected profits); *Fischer* v. *Kletz,* 249 F.Supp. 539, 541 (S.D.N.Y. 1966) (inflated earnings forecast disseminated both to public and to regulatory agency); *Nicewarner* v. *Bleavins,* 244 F.Supp. 261, 264 (D.Colo. 1965) (statements about expected profits, likelihood of success of venture, etc., not shown to be in bad faith by the evidence); *SEC* v. *Broadwall Sec., Inc.,* 240 F.Supp. 962, 968 (S.D.N.Y. 1965) (broker-dealer's predictions and opinions as to future market prices of stock).

basis. *SEC* v. *Okin,* 137 F.2d 862, 864 (2d Cir. 1943); *REA Express* v. *Interway Corp.,* 410 F.Supp. 192, 197 (S.D.N.Y. 1976) *citing Marx* v. *Computer Sciences Corp.,* 507 F.2d 485, 490 (9th Cir. 1974); *Schuller* v. *Slick Corp.,* [1974-1975 Binder] Fed.Sec.Law Rep. (CCH) ¶ 95,065 at p. 97,739; *In re Alexander Reid & Co., Inc.,* [1962-63 Binder] Fed. Sec.Law Rep. (CCH) ¶ 76,823 at p. 81,073; *In re Mac Robbins & Co.,* 40 S.E.C. 497, 502 (1961) *remanded sub nom. Kahn* v. *SEC,* 297 F.2d 112 (2d Cir. 1961) and *Berko* v. *SEC,* 316 F.2d 137 (2d Cir. 1963); *Jacobs, supra,* at 285; A. Bromberg, 2 *Securities Law* § 7.2(1) (1977); E. Weiss, *Registration & Regulation of Brokers and Dealers,* at 185 (1965).[5] Plaintiffs have not offered even a scintilla of evidence to show that Kohn's representations were groundless and absent proof, the requisite falsity is lacking to establish a misstatement within the purview of § 10(b).

Kohn's representations concerning his expertise in the securities field present a different problem. Unlike his investment advice, Kohn's repeated statements that he was a stockbroker (Gold Tr. 13) (Bader Tr. 60 (Jaffe Tr. 87-89) and his use of a business card stating that he was a "portfolio management specialist" (Exhibits 47, 48) were undeniably false. William Haneman, general partner of Wood Walker, testified that Kohn was employed by Wood Walker as a trainee, and as such, was permitted to accept buy or

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[5] *Hanly* v. *SEC,* 415 F.2d 589 (2d Cir. 1969) and *Hiller* v. *SEC,* 429 F.2d 856 (2d Cir. 1970) are not conrtary to this position. *Hanly* only held that a broker violates Rule 10b-5 when he makes a recommendation to a customer without an "adequate and reasonable basis for such recommendation." *Hanley* v. *SEC, supra,* at 597. After quoting its holding in *Hanly,* the Second Circuit noted specifically in *Hiller* that "there was substantial evidence in the record that . . . [the] salseman recommended Transition Stock on the basis of extravagant reports . . ." *Hiller* v. *SEC, supra,* at 858.

sell orders only under the supervision of a Wood Walker officer (Haneman Tr. 141).

[5, 6] Scienter and materiality, two principal elements of the private cause of action under 10(b), are also present with regard to Kohn's statements concerning his qualifications. Given defendant's deposition testimony that he was neither a "securities analyst" nor "portfolio management specialist" but knew that his business card listed him as such (Tr. 138-39), it is clear that Kohn acted with an " 'intent to deceive, manipulate, or defraud' ". *See Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). A willfully false statement is considered to be material if:

> [there is] a substantial likelihod that, under all the circumstances, the omitted [or misrepresented] fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosures of the omitted [or misrepresented] fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

TSC Industries v. *Northway, Inc.,* 426 U.S. 438, 449, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976).[6] Analyzed against this standard, the court finds that Kohn's misstatements were material. The court reaches this conclusion for two

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[6] Although this standard arose in the context of defining materiality for the purposes of Section 14(a) of the Exchange Act, "it is generally agreed that the same standard applies under § 10(b). *Joyce* v. *Joyce Beverages, Inc.,* 571 F.2d 703, 707 n. 6 (2d Cir. 1978) *citing Goldberg* v. *Meridor,* 567 F.2d 209, 218-19 (2d Cir. 1977); *see also SEC* v. *Bausch & Lomb Inc.,* 565 F.2d 8, 14-15 (2d Cir. 1977).

reasons. First, the expertise that Kohn held himself out as having affected the type of services that he could lawfully perform for investors. For example, testimony at trial indicated that while trainees at a brokerage firm can accept buy or sell orders by phone under the supervision of a broker, they cannot recommend the purchase of a security outside of the office. (Haneman Tr. 148-49). Second, the qualifications and expertise of a securities salesman are particularly significant criteria in evaluating any information as inherently speculative as future earnings predictions. Thus, a reasonable investor would certainly consider the total mix of information "significantly altered" if he learned that certain investment advice was being furnished to him by "a trainee" in the securities field rather than a "specialist". It is therefore irrelevant that the plaintiffs may not have known the precise training required for an individual to be licensed as a broker (Tr. 52, 84, 108); what is important is that the terms "broker" and "specialist" themselves connote a level of competence to the reasonable investor. Defendant's reliance on *Hayden* v. *Walston & Co., Inc.*, 528 F.2d 901 (9th Cir. 1975) is inappropriate. Although the Ninth Circuit held that a salesman's failure to reveal to his investors that he was not licensed to sell securities was not an omission of a material fact under Rule 10b-5, that decision predated the Supreme Court's ruling in *Northway* and relies heavily on the fact that the complaint contained no allegations that the salesman's omission rendered his other statements misleading. The complaint in this case, in contrast, alleges that the misstatements mere materially misleading (Complaint ¶¶ 21, 48, 75). These allegations are amply supported by the trial testimony to warrant a different result from that reached by the Ninth Circuit in *Hayden*.

[7, 8] The final element of a 10(b) cause of action based on affirmative misrepresentations is proof of reliance.[7] In such a case, "reliance" would seem to embody,

> two separate questions both of which are designed to determine whether the utterance by defendant caused the plaintiff to enter into the transaction and therefore his losses which allegedly flowed from the transaction. The two questions are did the plaintiff believe what the defendant said and was his belief the cause (or a cause) of plaintiff's action in entering into the transaction.

R. Jennings & H. Marsh, Securities Regulation 1063 (1977). Unlike the concept of materiality, which is couched in terms of "the reasonable investor", the concept of reliance requires a subjective inquiry to determine causation in fact. 3 *A. Bromberg, supra* § 8.6 at p. 209-11. *See also Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974); *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 238-39 (2d Cir. 1974).

[9-11] Based upon plaintiffs' testimony at trial, this court finds that Kohn's misrepresentations regarding his employment status caused plaintiffs Marbury Management and Bade to purchase securities from Kohn between the summer of 1967 and April 1969. Both of these plaintiffs testified repeatedly and without qualification that they would not have purchased the stocks had they known that Kohn was

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[7] The Supreme Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972) did not eliminate proof of reliance as an element in a private cause of action under Rule 10b-5. Rather, the Court held that proof of reliance would not be a prerequisite to recovery in situations involving a failure to disclose a material fact. *Id.* at 153-54, 92 S.Ct. 1456.

not a broker (Gold Tr. 24, 47-48, 51-53)[8] (Bader Tr. 66, 82). Plaintiff Jaffe, however, has not established to the court's satisfaction that he purchased the securities in question based upon Kohn's misstatement of his employment status. On the contrary, Jaffe's testimony indicates that he purchased in reliance upon his friendship with Kohn and Kohn's misrepresentations that Kohn had inside information regarding the companies whose stock was being recommended. (Jaffe Tr. 89, 90, 113-16). Thus, this court finds that only plaintiffs Marbury Management and Harry Bader have proven a cause of action under Section 10(b) of the Securities Exchange Act.[9]

2. *Reconsideration of Dismissal of Wood Walker*

Finding that there was "no evidence whatsoever . . . of any participation on behalf of defendant Wood Walker to manipulate with fraud or to in any way indicate that they intended to deceive their customers," the court dismissed at trial the complaint against Wood Walker (Tr. 188-90).

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[8] Robert Gold, President of Marbury Management, testified on behalf of the plaintiff corporation.

[9] The court dismisses those portions of the complaint that seek to recover for violations of § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a). The Court of Appeals for this circuit stated several years ago that the question whether § 17(a), a criminal provision, may be the source of an implied private right of action was an open question. *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1283 (2d Cir. 1969). Since that time, however, this district has repeatedly held that no such cause of action exists, *see, e. g., Scarfarotti* v. *Bache & Co.*, 438 F.Supp. 199, 207 (S.D.N.Y. 1977); *Architectural League of New York* v. *Bartos*, 404 F.Supp. 304 (S.D.N.Y. 1975), and this court adopts the reasoning set forth in those cases.

Since reliance is also an essential element of a common law fraud claim, see W. Prosser, *Torts* § 108 (4th ed. 1971), plaintiff Jaffe also fails to state a cause of action against defendant Kohn under this theory.

Plaintiffs have requested that the court reconsider the dismissal pursuant to Rule 60(b).[10] For the reasons stated below, plaintiffs' motion is denied.

The complaint alleges that Wood Walker (1) "knew or should have known that defendant Kohn was not a legally licensed allowed him to hold himself out as one authorized to transact buy and sell orders representative, but nevertheless . . ." (Complaint ¶¶ 12-13, 39-40, 66-67), and (2) knew that Kohn's statements concerning the investment potential of various securities were false when they were made (*Id.* ¶¶ 17, 46, 71). Although the complaint does not articulate with any more precision the theory upon which the plaintiffs seek to impose liability upon Wood Walker, plaintiffs' position as expressed at trial and in their post-trial memorandum of law indicates that they seek recovery against Wood Walker as an aider and abettor of Kohn's secuirties law violations.[11]

[12-14] In *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), the Supreme Court explicitly refused to decide whether § 10(b) and Rule 10b-5 may give rise to aiding and abetting liability. *Id.,* 425 U.S. at 192 n.7, 96 S.Ct. 1375. Since *Hochfelder,* however, the Second Circuit has held that these provisions permit the imposition of aiding and abetting liability. *Rolf* v. *Blyth,*

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[10] Although a final judgment dismissing the complaint against Wood Walker was never signed due to settlement negotiations with the remaining defendant, Rule 60(b) provides for relief from either a "final judgment, order or proceeding." Rule 60(b), Fed.R.Civ.P.

[11] Plaintiffs have not alleged that Wood Walker is liable to them either as a principal under the theory of respondeat superior or as a controlling person under Section 20(a) of the Exchange Act. Absent such allegations, the court need not consider Wood Walker's liability based upon either of these theories.

Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir. 1978); *Hirsch* v. *DuPont*, 553 F.2d 750, 759 (2d Cir. 1977). In order to impose aiding and abetting liability, the plaintiff must prove (1) that the primary party, here Kohn, committed a securities law violation; (2) that the aider and abettor knew of the violation; (3) and that the aider and abettor substantially assisted in effecting the violation. *Rolf* v. *Blyth, Eastman Dillon & Co., supra*, 570 F.2d at 47-48; *SEC* v. *Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908, 95 S.Ct. 826, 42 L.Ed.2d 837 (1975); *cf. Rochez Bros., Inc.* v. *Rhoades*, 527 F.2d 880, 886 (3d Cir. 1975); *Landy* v. *Federal Deposit Ins. Co.*, 486 F.2d 139, 162-63 (3d Cir. 1973) *cert. denied*, 416 U.S. 960, 94 S.Ct. 1979, 40 L.Ed.2d 312 (1974) (proof of "wrongful act" by primary wrongdoer suffices for first element). Judged against this standard, Wood Walker cannot be held liable under an aiding and abetting theory. Although Kohn's underlying violation satisfies the first element of the test, neither of the other requirements have been satisfied. All of the actions and inactions of Wood Walker, even when viewed most favorably to the plaintiffs, support a finding of only negligence. (Tr. 153-54). Thus, plaintiffs have failed to establish the element of recklessness enunciated in *Rolf*.[12] The court also found that Wood Walker neither supplied nor paid for Kohn's business cards (Tr. 182-83). Wood Walker thus did not in any way provide substantial assist-

[12] "Reckless conduct is, at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Rolf* v. *Blyth, Eastman Dillon & Co., supra*, 570 F.2d at 47 *citing Sanders* v. *John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977).

ance to Kohn in violating the securities law. The court's conclusions with respect to plaintiffs' attempts to satisfy the second and third elements of aiding and abetting liability are supported by *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975). In *Woodward*, the Fifth Circuit stated that the degree of knowledge required to impose aiding and abetting liability should depend on the uniqueness of the assisting activity in the particular enterprise. *Id.* at 97. Thus, in a case combining inaction and affirmative assistance, the Fifth Circuit "was loathed" to find 10b-5 liability without clear proof of intent to violate the securities law if the evidence shows no more than the performance of routine transactions. Accordingly, plaintiff's motion pursuant to Rule 60(b), Fed.R.Civ.P. is denied.

Damages

[15, 16] Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a) limits recovery in securities law actions to "actual damages". The appropriate measure of damages in this Circuit for the type of violations proven in this case is the amount of each defrauded buyer's net economic loss. This figure is calculated by determining each plaintiff's gross economic loss—the difference between the purchase and resale prices of the securities—and subtracting "an appropriate offset dictated by the particular facts of the case." *See Clark* v. *John Lamula Investors, Inc.*, 583 F.2d 594, 604 (2d Cir. 1978). Although Robert Gold, president of Marbury Management, testified at two post-trial hearings that plaintiffs Marbury Management and Harry Bader learned on approximately January 28, 1970 that Kohn was not a portfolio management specialist, Marbury Management did not sell its D.W.G., Responsive Environment, and Universal

Container securities until over a year after that date, and Bader continues to hold all of the securities that Kohn purchased for his account. Accordingly, applying the general principles of the *Clark* decision to the facts of this case, the court determines that the plaintiffs' gross economic losses must be reduced by the amount that the plaintiffs lost due to their failure to sell their securities within a reasonable period after discovering defendant's fraud.[13] Based upon the stipulation entered into by the parties regarding the market value of the securities on January 28, 1970 and the schedules of purchases attached to the complaint, Marbury Management's net economic loss is $28,727.27 and

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[13] The Second Circuit seems to regard plaintiff's failure to mitigate damages as a posible ground for reducing the amount of the damage award in an appropriate case. *See Clark* v. *John Lamula Investors, Inc., supra,* at 604 n. 9. Such an approach has received support from courts and commentators alike because it attempts to calculate the amount of damages based upon losses that are truly attributable to the fraud. *See Harris* v. *American Investment Co.,* 523 F.2d 220 (8ht Cir. 1975), *cert. denied,* 423 U.S. 1054, 96 S.Ct. 784, 48 L.Ed.2d 643 (1976); *Foster* v. *Financial Technology, Inc.,* 517 F.2d 1068 (9th Cir. 1975); *Esplin* v. *Hirschi,* 402 F.2d 94 (10th Cir. 1968), *cert. denied,* 394 U.S. 928, 89 S.Ct. 1194, 22 L.Ed.2d 459 (1969); *Competitive Ass'n, Inc.* v. *International Health Services,* [1974-1975 Binder] Fed.Sec.Law Rep. (CCH) ¶ 94,966; *Fox* v. *Glickman Corp.,* 253 F.Supp. 1005 (S.D.N.Y. 1975); Reder, Measuring Buyer's Damages in 10b-5 Cases, 31 Bus. Lawyer 1839 (1976). Thus, if the plaintiff continues to hold the stock after the discovery of the fraud, he can be deemed to have made a "second investment decision", *see Harris* v. *American Investment Co., supra,* 523 F.2d at 228, based on the "total mix" of information now available.

Bader's net economic loss is $20,502.25.[14] Let the Clerk enter judgment for plaintiff Marbury Management in the amount of $28,727.27 and judgment for plaintiff Bader in the amount of $20,502.25, both plus interest from January 28, 1970.

[14] These figures were determined as follows:

MARBURY MANAGEMENT

Name of stock	# of shares	Date Purchased	Purchase Price	Market Stipulated Value Per Share as of 1/28/70	Market Value of All Shares Owned as of 1/28/70	Loss
D.W.G. Corp.	1000	8/27/68	14,967.50	bid $4 7/8	4,875.00	$10,092.50
Responsive Environment	100	12/ 6/68	3,385.75	bid $8	800.00	2,585.75
Universal Container	500	3/26/69	12,406.25	bid $9	4,500.00	7,906.25
Unexcelled	500	1/20/69	22,205.00	[sold on 3/26/69 for $13,312.23]		8,892.77
						$29,477.27
						− 750.00*
					Total loss	$28,727.27

* Stipulated amount that defendant Kohn previously paid to defendant Marbury Management regarding its loss on D.W.G. stock.

HARRY BADER

Responsive Environment	500	12/13/68	16,928.75	bid $8	$4,000.00	$12,928.75
Capital Holding	100	12/27/68	687.50	[no market value]		687.50
Commuter Airlines	500	9/27/68	6,312.50	[no market value]		6,312.50
Stanrock Uranium	200	1/ 6/69	973.50	bid $2	400.00	573.50
					Total Loss	$20,502.25

Supreme Court, U. S.
FILED
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No. 80-342.

IN THE

Supreme Court of the United States

October Term, 1980

WOOD WALKER & CO.,

Petitioner,

MARBURY MANAGEMENT INC., and HARRY BADER,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Brief for Respondents in Opposition to Petition for Certiorari.

GEORGE BERKOWITZ
Attorney for Respondents
233 Broadway
New York, N. Y. 10279
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1980.

WOOD WALKER & CO.,

Petitioner,

v.

MARBURY MANAGEMENT Inc. and HARRY BADER,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Brief for Respondents in Opposition to Petition for Certiorari.

Questions Presented.

The first question as posed by petitioner, namely:

> "Is the common law concept of *respondeat superior* read into the Securities Exchange Act of 1934 and specifically into Sec. 10(b) (15 U.S.C. Sec. 78j[b]) to hold an employer absolutely liable without *scienter* for the acts of its employees?"

may create the erroneous impression that the reversal by the Circuit Court of the dismissal of the complaint as

against petitioner was solely on the ground that the lower court erred in not applying the concept of *respondeat superior* and that there was no proof of *scienter.*

The record is to the contrary as the Circuit Court held that on the whole of the evidence presented to the trial court there was not only the applicability of *respondeat superior,* but there were other theories of liability which the lower court incorrectly disregarded. The Circuit Court stated:

> "The way in which the case was tried, and the shift in the emphasis of argument on the motion to dismiss arising from the introduction of Ernst & Ernst into the discussion may explain Judge Gagliardi's taking the position that he had to consider only the aider and abettor analysis, but the record evidence tending to support the plaintiffs' claim on the other two grounds was before the court, *and, on the whole of that evidence, the three theories of liability—aider and abettor, controlling person, and respondeat superior—equally presented themselves for resolution"* (A13). (Emphasis added.)

Moreover, and as also pointed out in the Circuit Court's prevailing opinion, there were erroneous rulings by the trial court on the admission of material evidence and in the evaluation thereof as more fully referred to below.

The formulation of petitioner's second question is not apropos:

> "If a collateral misstatement is made prior to the purchase of a security at its fair market value and

> the security thereafter declines in price solely due to market forces, are damages for such decline recoverable by the purchaser?''

The uncontradicted testimony on that subject establishes that the false representations were made by petitioner's employee Kohn on which respondents relied to their damage.

Examples of these misrepresentations are set forth below.

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Statement of the Case.

In its "Statement of the Case," petitioner alleges that Marbury and Bader (plaintiffs below) opened accounts with Wood Walker & Co. in the summer of 1968 and that *subsequently* and in September of that year the "personal friend" of respondents joined Wood Walker as a "registered representative-trainee," and that "* * * plaintiffs 'apparently' dealt 'principally' " with Alfred Kohn in their buying of stock at Wood Walker.

This is a distorted and misleading version of the record. Actually, all sales were made by Kohn through Wood Walker commencing the summer of 1968 before Kohn was officially hired and Kohn given credit by Wood Walker for a share of the commissions.

Concerning the Parties and the Trial.

This was a non-jury case and neither petitioner, Wood Walker, nor Kohn, the co-defendant, submitted any proof, documentary or otherwise, but, instead, rested at the close of respondents' case, then moved to dismiss the complaint, and plaintiff cross-moved for judgment. Accordingly, the record consists solely of the testimony and evidence of respondents and documentary proof submitted by them.

The causes of action by Jaffe (a third plaintiff) were dismissed for failure of proof.

Petitioner's motion to dismiss was granted as against the respondents and plaintiff's cross-motion granted only to the extent of directing judgment against the defendant Kohn.

Prior to trial, the complaint* was dismissed against the New York Stock Exchange, one of the original defendants.

Concerning the Testimony and Exhibits.

The first witness, Robert Gold, president of Marbury Management Inc., testified that he became acquainted with the defendant Alfred Kohn when they were vacationing at a summer resort in Spring Valley, New York, known as Baders, owned and operated by the plaintiff Harry Bader, who also met Kohn in that fashion.

At the time they met Kohn, Marbury and Bader had stock brokerage accounts with brokers other than Wood Walker, and Mr. Gold testified that there had been no reason to deal with Wood Walker, rather than his then brokerage firm or to make the purchase from Wood Walker in its Bronx office and through Mr. Kohn but he was persuaded to do so "based on the information that he gave to us" (TT pp. 51a, l. 19-52a, l. 8).

Kohn claimed to be a stock broker connected with Wood Walker, and separately gave Gold and Bader his business card.** On one side of the card in large type was the name of Al Kohn—under that "Security Analyst" and

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A copy of the complaint is set forth in respondents' appendix. Such dismissal was at the time of the substitution of present counsel for respondents. In dismissing the complaint against the Stock Exchange, the court stated that, even if the Exchange was derelict for not making any punitive action against petitioner, " * * it would not give rise to any liability since no action taken at that time would have prevented plaintiffs' losses. The Exchange investigation continued until at least April 29, 1969 when Kohn was interrogated by the Exchange (the transcript of which is annexed to the Exchange affidavit) and the last transaction complained of by plaintiffs occurred on March 26, 1969."

**Each separate portion of the card marked at the trial as Exhibits 47 and 48, but in the Circuit Court, Appendix of Exs. as 1E and 2E.

on the bottom, "Wood Walker & Co.," its Bronx office address and telephone number.

The other side of this two-fold card stated in large type "Portfolio Management Specialist" and beneath that "Wood Walker & Co." and again, its Bronx office address and telephone number.*

In August, 1968, Kohn telephoned Gold urging that he purchase shares of DWG Corp. stating that he was familiar with the company and had met with its financial officer, that it was a small conglomerate and was in the process of making a number of acquisitions and this would cause the market price of its shares to go up. Although this purchase was made before Kohn was officially employed by Wood Walker, nevertheless, as above stated, Marbury received a confirmation of the sale from Wood Walker, the same as a subsequent purchase from Kohn.

All orders for purchases resulted from Kohn's representations and recommendations. At no time was there any discussion of the transactions with anyone else at Wood Walker other than Kohn (TT pp. 50, 51).

Thus, petitioner's statement that Marbury "dealt principally" with Alfred Kohn in their buying of stock at Wood Walker is misleading. All dealings and purchases were only with Kohn.

Kohn was so positive that by reason of his private information that the price of DWG stock would go up that he personally guaranteed payment of losses, if any.

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*On his examination before trial, Kohn testified that these cards were supplied by Wood Walker without any cost to him.

No acquisitions were made by DWG as represented by Kohn and the market price continued to go down.

The next stock recommended by Kohn was Unexcelled, which Kohn falsely represented was in the process of a "big merger."

Kohn went so far as to tell Gold that, on the Unexcelled purchase, no money need be paid—that "it is going up immediately, * * * you could buy and sell it within two weeks and just keep the profits" and "I do it all the time and Wood Walker does it all the time" (TT p. 19, ll. 20-25).

Likewise with all the stocks purchased by Marbury, none of Kohn's representations were true and "the items never transpired that he said were going to happen" (TT p. 50, ll. 4-7).

The next purchase was on December 6, 1968, of 100 shares of Responsive Environment. Mr. Kohn told Mr. Gold that he had "* * * a relative of his who was either friendly or connected with the company * * * and that a very favorable article was coming out in the New York Times which would cause the stock to go up in fact" and recommended that the stock be purchased.

There was no article which appeared in the New York Times but, instead, an advertisement from a brokerage house, and the stock went down in price (TT p. 18, ll. 5-15).

The next purchase was of Universal Container. Mr. Gold testified that Mr. Kohn:

> "told me he had certain inside information with respect to that company; that they were going to acquire certain casinos as in the Catskill Mountains and also in Europe, which should cause the stocks

to go up considerably. None of these events ever took place" (TT p. 20, ll. 10-16; p. 53a Appendix U. S. Court of Appeals).

After testifying to the losses incurred, the record indicates the following:

"The Court: If you had not received advice from Mr. Kohn with respect to the stocks, you would not have purchased them?

"Is that the question?

"The Witness: I never heard of these companies. I never would have purchased the stock.

"Q. Would you have purchased the stock from Wood Walker had you known that Mr. Kohn was not a registered representative? A. No, I wouldn't have purchased them" (TT p. 24, ll. 3-12).

Mr. Bader testified in a similar fashion of the fraudulent misrepresentations made by Kohn. The same as Gold, he had an account with another brokerage firm and would not have made purchases from Wood Walker through Kohn, if not for the representations.

The New York Stock Exchange made an investigation of the operations of Wood Walker & Co. and found that its rules were violated in that Kohn, only a trainee and not a licensed representative, gave advice to customers and took orders for the purchase and sale of stock on behalf of Wood Walker, who not only issued confirmations and statements to customers, but also credited Kohn with a percentage of the commissions on his sales including those to respondents.

In dismissing the complaint against the Stock Exchange, the court noted that at the time of the transactions Kohn had a pending application for license but no license was ever issued.

Erroneous Rulings by Trial Court.

A. On July 19, 1977, on the argument of petitioner's motion to dismiss at the close of plaintiff's case, the court stated:

> "It is undisputed that Alfred Kohn was employed by the defendant Wood Walker & Company. I find that he was employed as a trainee and accepting the plaintiffs' facts in their most favorable light, as I must do on a motion of this kind. I think the evidence in its most favorable light to the plaintiffs is that during the course of his employment with Wood Walker & Company the defendant Alfred Kohn did solicit business from the three plaintiffs here *and made various representations to each of the plaintiffs with respect to each of the issues which they purchased* as set forth in Schedules A, B and C annexed to the complaint" (TT p. 222a). (Emphasis added.)

Notwithstanding this finding in 1977 of "representations," by Kohn, thereafter, in the Court's subsequent opinion, dated April 25, 1979, the Court then characterized the statements of Kohn as "predictions" and not as "representations."

B. Although the Court had previously correctly ruled that on a motion to dismiss at the close of plaintiff's case, plaintiff's evidence must be accepted in the most favorable light, nevertheless, thereafter, in granting petitioner's motion to dismiss, the Court applied a more rigid rule stating:

> "I find, however, that the plaintiffs have not sustained the burden of proof by a fair preponderance of the credible evidence * * *" (TT p. 223a).

As judgment was directed against Kohn and affirmed by the Court of Appeals, the question of whether Kohn's statements were representations or predictions were moot as against Kohn. However, as against petitioner, the Court's earlier ruling that the statements by Kohn were "representations" should be considered as the "Law of the Case" in determining the liability of petitioner as Kohn's employer.

C. The trial court erred in ruling that Wood Walker did not supply or pay for Kohn's business cards. The court stated:

> "The court also found that Wood Walker neither supplied nor paid for Kohn's business cards. Wood Walker thus did not in any way provide substantial assistance to Kohn in violating the securities law" (TT pp. 182-3).

This finding is contrary to the record. The defendant, Kohn, had testified on his examination before trial that Wood Walker had printed and paid for them.

Mr. Haneman, a partner of Wood Walker, subpoenaed by the respondent as an adverse witness, and when asked about Kohn's testimony that the cards were paid for and furnished by Wood Walker Mr. Haneman testified:

> "I wouldn't have any way of knowing it. They are not standard cards of Wood Walker. They are prints. To my knowledge we have never had anything like that."

When this subject was pursued, the interrogation on that subject concluded as follows:

> "In view of that testimony by Mr. Kohn under oath, would you tell us now whether or not Wood

> Walker printed, paid for and handed these cards over to Mr. Kohn, Exhibits 47 and 48? A. No, sir, I can't even say any more than I did before.
>
> "Q. Would you deny it? A. I certainly would not. I have no knowledge of it. I have never seen them before."

Thus, the only positive evidence in the record concerning the business cards was that they were paid for and supplied by Wood Walker.

Petitioner was thus joined with Kohn, not only as an employer and thus a controlling person, but also as an aider and abettor.

D. The Court erred in excluding Exhibits 52 and 53. Exhibit 52 consisted of the correspondence between Mr. Haneman, a partner of Wood Walker, and the New York Stock Exchange, which summarized the investigation of the Exchange and referred to the improper activities of Kohn as a trainee, in dealing with customers, giving advice, making sales, improperly performing duties as a registered representative and the recipient of a drawing account for a portion of the brokerage commissions.

Exhibit 53 was a certified copy of the transcript of the investigation by the New York Stock Exchange of Wood Walker, including testimony of the defendant Kohn.

At one point, petitioner's counsel stated he had no objection to the introduction of said report (TT p. 91a).

When again request was made to introduce this exhibit, during the course of the colloquy that ensued, petitioner's counsel stated:

> "* * * it was being offered as part of the plaintiffs' case and obviously, if the Court chooses to take it as an exhibit, it may" (TT p. 217, ll. 17-19).

However, the Court did not accept this concession and stated to Mr. Crocco:

> "The Court: No, you objected" (TT p. 217, l. 20).

Although Mr. Crocco remained silent and had not voiced any objection, nevertheless, the Court stated:

> "I would say that the objection is well taken and I have to sustain the objection" (TT p. 217, l. 23).

In requesting the Court to reconsider its exclusion of Exhibit 53, respondents' counsel cited the case of *U. S. v. Solomon,* 519 Fed. 2d 863.

Although the Court acknowledged that

> "* * * any statement of any defendant can be admitted" (TT p. 184a).

nevertheless, and although Exhibit 53 contained the statement of the defendant Kohn, the Court ruled that the *Solomon* case was not apropos as that was a criminal case.

This ruling was erroneous as the rules of evidence are less restrictive in a nonjury civil case, as this one, than in a contested criminal jury trial.

E. The Court overlooked the undisputed and material fact that petitioner improperly maintained a ledger card under a number assigned to Kohn, in the same way as it did with registered representatives, on which Kohn was credited with a share of the commissions on the sales made by him on behalf of petitioner including sales to respondents. This ledger card was in evidence (Exhibit 56).

F. At the close of respondents' case their counsel moved to conform the pleadings to the proof but this was limited by the questioning of the court, to the amounts set forth in the schedules (TT pp. 183, 18a).

The court ruled that respondents' claim was limited to 10b-5. Respondents' counsel disputed such limitation as follows:

> "Mr. Berkowitz: I don't think this is limited to 10b-5, Your Honor. Your Honor has a right, as a matter of simple justice here to find we may have a case also in negligence and deriliction by Wood, Walker because of Kohn. That could be even at this late stage, as Your Honor well knows, a ruling based upon any theory at all which might be applicable, which might result in recovery.
>
> "The Court: You are in Federal Court now, you have several claims. That is all I can consider."*

Such ruling, as well as the Court's failure to liberally construe plaintiffs' case on defendant's motion to dismiss,

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In granting the motion for judgment against Kohn, the court recognized that the complaint alleged " * * violations of Section 10(b) of the Securities Exchange Act of 1934 ('Exchange Act'), 15 U.S.C. S. 78b, Section 17(a) of the Securities Act of 1933, 15 U.S.C. S. 77q, and common law fraud" (TT 295a).

As stated by the Court of Appeals (A14):

> "Generally a complaint that gives full notice of the circumstances giving rise to the plaintiff's claim for relief need not also correctly plead the legal theory or theories and statutory basis supporting the claim. *Rohler v. TRW, Inc.*, 576 F. 2d 1260, 1264 (7th Cir. 1978); *Hostrop v. Board of Junior College District No. 515*, 523 F. 2d 569, 581 (8th Cir. 1975), cert. denied 425 U. S. 963 (1976); *Bramlet v. White Star Ltd.*, 221 F. 2d 189, 196 (2d Cir. 1955); cf. *New York State Waterways Assn. v. Diamond*, 469 F. 2d 419, 421 (2d Cir. 1972) (court's duty to read pleading liberally to determine whether facts alleged justify taking jurisdiction on grounds other than those most artistically pleaded).

was in violation of the Federal Rules of Evidence, Article 1, Sec. 102, which provides that there should be liberal construction for "truth and justice."

G. The trial court erred in its failure to take cognizance of the undisputed evidence that petitioner, as the employer of Kohn, was responsible for his acts in the performance of his services and in permitting him to give advice and take orders for the purchase and sale of stocks and conduct business for petitioner in its usual course of business, in issuing its confirmations to respondents for such transactions and sharing its commissions with Kohn, petitioner was liable not only under the controlling person relationship, but also, as principal of its agent Kohn for his malfeasance, as well as under the *respondeat superior* doctrine. Moreover, petitioner was in a fiduciary position on behalf of respondents and thus under a duty of a higher degree of care.*

Reasons for Denying the Writ.

1.

Petitioner has not exhausted its remedies. Although the decision by the Court of Appeals affirmed the judgment against the defendant Kohn, and that is final, the judgment in favor of petitioner was reversed and a new trial granted of the claims of respondents against petitioner. Accordingly, a review by this Court would be academic and would become moot if after a new trial, the lower court makes a determination in favor of petitioner.

2.

The two questions presented for review by petitioner are not apropos. The reversal by the Court of Appeals was on

*See Law Review article, "Brokers' Derivative Liability: Does Supervision Make a Difference?" (Brooklyn Law Review, Vol. 41, No. 2 1974).

the basis of the errors of the trial court in failing to consider not only liability under Section 10(b) U.S.C., Section 78j(b), but also for the failure to consider a theory of liability other than *respondeat superior,* namely, aider and abettor and controlling person.

Additionally, the reversal was based on erroneous rulings of the trial court on evidence and a motion to conform the pleadings to the proof. Errors of the trial court are hereinabove more particularly referred to under the heading of "Erroneous Rulings by the Trial Court."

3.

Petitioner's main argument is that the petition should be granted because of the conflict of the circuits as to whether *respondeat superior* can be a basis for liability under Section 10(b).

However, such a conflict is academic in this case, as petitioner thus overlooks the ruling of the Circuit Court that it was error for the District Court to not consider liability as an aider and abettor and controlling person.

In effect, petitioner is urging that respondents be restricted to a claim under 10(b) and thus glosses over FRCP 15(b) that issues tried by implied consent are to be treated as if raised in the pleadings.

Moreover, the allegations of the complaint were sufficient to impose liability on grounds other than 10(b).

As stated by the Circuit Court (Appendix A12-13):

> "* * * the evidence upon which plaintiffs rely in this court, as in the district court, and the allegations of fact made in the complaint are alike completely descriptive of the transactions and of the

> roles of the actors in them, and they are the evidence and allegations relevant to a determination of the *respondeat superior* issue, and, inevitably, of the Section 20(a) issue. Plaintiff's counsel argued the *respondeat superior* issue orally at the trial, and the bare failure to reiterate it in the closing brief in the district court cannot be considered an abandonment of the point."

Presumably, petitioner is urging that no other section of the securities laws should be applied. This would violate the Federal Rules of Evidence which require liberal construction for "truth" and "justice." The proof submitted supports a finding for respondents on all the theories referred to by the Circuit Court.

4.

The securities laws were designed to complement common law liability—not to restrict liability. The '33 and '34 Acts themselves evidence this purpose. Each contains a savings clause which preserves all rights and remedies existing at law or in equity. The liberal and flexible construction of the securities laws mandated by their broad, remedial purposes, disallows a narrow interpretation which would foreclose a claimant from relief unless and only if he pursues his claim under a particular and specified section of the securities laws, so that form take precedence over substance.

In *J. I. Case v. Borah,* this Court stated that the District Courts have broad remedial powers to "adjust their remedies so as to grant the relief necessary." 377 U. S. 426 (1963).

This case has been pending since August, 1973, and it would be unjust to further defer a final determination of

respondents' lawsuit and subject them to further expense and inconvenience.

Except for the measure of damages, the cases cited by petitioner are all on the subject of Section 10(b)5. As the reversal was based on other grounds, there is no point in distinguishing these cases from the case at bar. However, the citation at page 14 of *Hayden, et al., v. Walston & Co., Inc., et al.,* with the flat statement that

> "The facts and the issue are as identical as two cases can be."

requires a response.

In the *Hayden* case, plaintiff's sole complaint was that after the purchase of stock selected by plaintiff, without the advice or representation of defendant's representative, and the stocks went down in price, it was then learned that the salesman was not a registered representative and suit instituted.

The lack of license or registration played no part in plaintiff's selection of the stocks that were purchased by Hayden and whether the stocks went up or down in price was the risk taken by plaintiff of his own volition.

Also, and as stated by the Circuit Court (A10):

> "The second ground of suit rejected in the Hayden case, that a private right of action could be predicated on the violation of the National Association of Securities Dealers rules, has not been relied upon in this case, and was not a ground of decision in the district court."

In our case, the respondents were lured away from the brokerage firms with which they were then dealing, by the

representations of Kohn not only that he was a broker with petitioner's firm, but also that he was a "securities analyst" and a "porfolio management specialist," that he had inside information and also made representations of factual information which would cause his recommended stocks to go up in price, and on all of the foregoing respondents purchased said stock from petitioner, through its employee Kohn. The representations were false and respondents suffered substantial losses.

In fact, with one stock, Kohn was so positive of his alleged inside information that the price would immediately go up, he stated that there was no need to make any payment on the purchase of the stock as it could be sold at a higher price very quickly before payment of the purchase price would be required.

The *Hayden* case is completely different and we agree with petitioner that if in our case the facts were the same as in the *Hayden* case, there would be no liability.

Petitioner argues that scienter must be established in support of a 10(b) action and states that the Second Circuit in this case

> "* * * held that the brokerage house is liable without intent."

We respectfully differ and the opinion speaks for itself.

In any event there was substantial unrebutted proof that petitioner, as the employer, placed Kohn in a position in which he improperly, within the scope of his apparent authority, and in the name of petitioner, at its brokerage office and over its telephone, not only made sales of stocks to respondents but also made representations of so-called inside information, etc. More than that, in violation of the

regulations of the N. Y. Stock Exchange, petitioner shared its commissions with Kohn, a trainee without the required license. That certainly establishes intent.

It is significant that on the subject of intent, petitioner did not attempt to establish a good faith defense and based upon the record, it would have been impossible to do so.

Petitioner states at page 4:

> "Nonetheless, the court below held that an entity whose only involvement was that it was the wrongdoer's employer has no defense and is absolutely liable for any wrongdoing."

This statement is not supported by the record.

CONCLUSION.

Respondents respectfully submit that the petition should be denied.

Dated: October 22, 1980

Respectfully submitted,

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APPENDIX.

Complaint.

UNITED STATES DISTRICT COURT,

SOUTHERN DISTRICT OF NEW YORK.

MARBURY MANAGEMENT, Inc., HARRY BADER and HARVEY JAFFE,

Plaintiffs,

against

ALFRED KOHN, WOOD, WALKER & Co., and THE NEW YORK STOCK EXCHANGE,

Defendants.

Plaintiffs, complaining of the defendants, by their attorneys, Hauser & Rosenbaum, P.C., respectfully allege:

JURISDICTION

1. This action is brought under Section 10 B of the Securities Exchange Act of 1934 (15 U.S.C. 78j [b]; Rule 10b5 (17 C.F.R. 240.10b5); Section 17 (a) of the Securities Act of 1933 (15 U.S.C. 77q); and Section 27 of the Securities Exchange Act of 1933 (15 U.S.C. 78aa).

VENUE

2. All defendants in this action reside in the Southern District of New York.

THE PARTIES

3. Plaintiff, Harvey Jaffe ("Jaffe") is an individual residing in the County of Bronx, City and State of New York.

4. Plaintiff, Harry Bader ("Bader") is an individual residing in Spring Valley in the State of New York.

5. Plaintiff, Marbury Management, Inc. ("Marbury") is a corporation existing by and under the laws of the State of New York, and with its principal office in the City and State of New York.

6. Defendant, Alfred Kohn ("Kohn") is an individual residing in the County of Bronx, City and State of New York, and at relevant times herein, was an agent, servant and/or employee of defendant Wood, Walker & Co.

7. Upon information and belief, Wood, Walker & Co., defendant, is a New York corporation with its principal place of business in the City and State of New York. At the times of the actions hereinafter complained of, it was and still is a member of the New York Stock Exchange, American Stock Exchange, dealt in over-the-counter securities, was duly authorized to transact buy and sell orders in connection with securities in all of the above markets.

8. Defendant, New York Stock Exchange, is a National Securities Exchange registered under Section 6 of the Securities Exchange Act of 1934.

9. That beginning in the summer of 1967, defendant Kohn met the officers of plaintiff Marbury and in order to induce the said plaintiff to purchase securities through

him, falsely represented and held himself out to be lawfully licensed registered representative to said plaintiff, and represented to said plaintiff that he was authorized to transact buy and sell orders on behalf of the defendant Wood, Walker & Co.

10. That plaintiff Marbury did, in reliance on the above representation, place orders to buy and sell securities with defendant Wood, Walker & Co., through defendant Kohn, and defendant Wood, Walker & Co. did, in the ordinary course of business, execute all such transactions.

11. The plaintiff Marbury did not deal with Wood, Walker & Co. through anyone other than defendant Kohn, and any instructions or directions in relation to said securities transactions and to the account of plaintiff Marbury were given to Kohn and acted upon by Wood, Walker & Co.

12. That defendant Wood, Walker & Co. knew or should have known that defendant Kohn was not a legally licensed representative, but nevertheless permitted him to hold himself out to the plaintiff Marbury, and others as such and permitted and allowed him to hold himself out as one authorized to transact buy and sell orders on behalf of the defendant Wood, Walker & Co. to the plaintiff Marbury and others.

13. Defendant Wood, Walker & Co. knew or should have known at all times hereinmentioned, that defendant Kohn was not licensed to act as a registered representative; yet, upon information and belief, defendant Wood, Walker & Co. did execute buy and sell orders through the aforesaid stock exchanges for the plaintiff Marbury and others, upon receipt of instructions from defendant Kohn.

14. That the representations by defendant Kohn that he was a duly authorized registered representative were, in

fact, false and untrue and known by him to be false and untrue at the time said representations were made to plaintiff Marbury, and were made for the purpose of inducing this plaintiff and others to buy and sell certain securities through him.

15. Plaintiff Marbury did instruct and order defendant Kohn to purchase and sell certain securities on certain dates as indicated in Schedule "A" attached hereto, in reliance on his misrepresentations.

16. That on certain dates, certain stocks were purchased through the defendant Wood, Walker & Co. (see Schedule "A") in reliance upon the defendant Kohn's relating to plaintiff Marbury, and others, information about said securities as to their worthiness, value, and investment potential, the said securities were purchased upon reliance by the plaintiff Marbury and others on the representation that the defendant Kohn was a lawfully licensed registered representative.

17. Defendant Kohn made such representations and, in fact, knew they were false and made them with the intent to deceive and defraud the plaintiff Marbury, and others, and to induce plaintiff Marbury, and others to purchase the said securities and pay the sums of money therefor. Defendant Wood, Walker & Co., at the time the defendant Kohn made such false representations, knew said representations were false and fraudulently executed buy and sell orders in behalf of the plaintiff and others with full knowledge that the defendant Kohn was not a lawfully licensed registered representative and did retain for its profit and gain the commissions charged the plaitniff, and others, in connection with said transaction.

18. Defendant Kohn, in addition to representing himself to be a lawfully licensed representative, also advised the plaintiff Marbury and others, that he had personal knowledge of the investment potential of stocks

traded in the over-the-counter market and on the American Stock Exchange, respectively known as D.W.G. Corporation, Responsive Environment Corp. (over-the-counter), Universal Container and Unexcelled, Inc. (American Stock Exchange); and his opinion of the investment potential of these aforesaid stocks, was based upon personal conversations and meetings with officers and other persons who had unique information as to the transactions of the corporations and their effect on the market price of the aforesaid stocks.

19. Upon information and belief, at the time these representations were made, the said representations were false and, in fact, the defendant Kohn had no unique or special information of the investment potential of said corporations which would lead to an increase in the market price of said stocks.

20. Defendant Kohn, at the time of the making of said representations, knew that they were false and that he made said representations with the intent to deceive the plaintiff Marbury, and others, and to induce it to purchase the aforesaid stocks, through his firm, the defendant Wood, Walker & Co.

21. Defendants' said actions, omissions and misrepresentations constitute a violation of Rule 10b5 of the Securities and Exchange Commission (17 C.F.R. 240.10b5) and Section 10b of the Securities Exchange Act of 1934 (15 U.S.C. 78; [b]), in that they constituted the employment of a device, scheme and artifice to defraud, by the making of untrue statements of material facts, and the failure to state certain material facts, so the statements made would not be misleading and constituted acts and practices in a course of business operating as a fraud upon the plaintiff Marbury, and others.

22. Said acts, misrepresentations and omissions took place in connection with the purchase and sale of securities and operated in part through the mails, through regulated stock exchanges and other instruments of interstate commerce.

23. That plaintiff was ignorant of the falsity of the representations of the defendant Kohn, and that the defendant Kohn was not a legally licensed representative, but believed the representations to be true and relied upon the said statements and representations made to it by the defendant, as aforesaid, including his representations as to special knowledge in relation to the securities which he induced plaintiff Marbury to purchase.

24. Plaintiff was induced to and did purchase securities in the sum of approximately Fifty Three Thousand ($53,000.00) Dollars in reliance on the abovementioned representations. Plaintiff Marbury sold certain of the said securities suffering losses on said securities in the sum of Eight Thousand Eight Hundred Ninety Two Dollars and Seventy Seven Cents ($8,892.77); plaintiff Marbury still owns certain securities purchased in reliance on the statements of the defendant Kohn, and on these had losses of Twenty Four Thousand Nine Hundred and Thirty Five ($24,635.00) Dollars (losses are detailed in the attached Schedule "A").

25. By virtue of the defendants' abovementioned wrongdoings, plaintiff Marbury has been damaged in the amount of Thirty Three Thousand Eight Hundred Twenty Seven Dollars and Seventy Seven Cents ($33,527.77), together with interest thereon from March 30, 1969.

COUNT II

26. Plaintiff repeats, reiterates and realleges Paragraphs numbered "9" through "20" and "22" and "23" of County I, as if therein set forth at length.

27. Defendants' said actions, omissions and misrepresentations constitute a violation of Section 17a of the Securities Act of 1933 (15 U.S.C. 77q).

28. By virtue of the defendants wrongdoing, abovementioned, plaintiff Marbury has been damaged in the amount of Thirty Three Thousand Eight Hundred Twenty Seven Dollars and Seventy Seven Cents ($33,827.77) together with interest thereon from March 30, 1969.

COUNT III

29. Plaintiffs repeat, reiterate and reallege each and every one of the allegations contained in Paragraphs "9" through "20" and "23" of Count I of this complaint, as if herein fully set forth.

30. The facts above stated also constitute actionable fraud under the laws of the State of New York. That based on the fraudulent acts above mentioned, plaintiff Marbury did make the following purchases of security: 1,000 shares of D.W.G. Corporation purchased on August 27, 1968 for approximately Fourteen Thousand Seven Hundred Fifty ($14,750.00) Dollars; 100 shares of Responsive Environments purchased on December 6, 1968 for approximately Three Thousand Three Hundred Eighty Five ($3,385.00) Dollars; 500 shares of Unexcelled, Inc. purchased on January 20, 1969 for a price of Twenty Two Thousand Two Hundred Five ($22,205.00) Dollars; 500 shares of Universal Container purchased on or about the 26th day of March, 1969 for a price of Twelve Thousand Four Hundred Six Dollars and Twenty Five Cents ($12,406.25).

31. That losses were suffered on each of these purchases of securities, as follows: the shares of D.W.G. Corporation purchased for $14,750.00 have current value of $3,000.00 for a loss of $11,750.00; the 100 shares of Responsive Environment purchased for $3,385.75 have a current value of $200.00 for a loss of $3,185.00; the 500 shares of Unexcelled, Inc. purchased for $22,205.00 were sold on March 26, 1969 for $13,312.23 for a loss of $8,892.77; the 500 shares of Universal Container bought on March 26, 1969 have a current value of approximately $2,700.00 for a loss of $9,700.00.

32. All of the above losses were sustained as a result of the fraudulent acts of the defendant, resulting in a loss to plaintiff in the amount of Thirty Three Thousand Eight Hundred Twenty Seven Dollars and Seventy Seven Cents ($33,527.77), together with interest thereon from March 30, 1969.

COUNT IV

33. Plaintiff repeats, reiterates and realleges Paragraphs numbered "9" through "20", "22", "23", "24" as if herein set forth at length.

34. Defendant New York Stock Exchange failed, neglected and refused to fulfill its obligations under Sections 6(a) (1) and 6 (d) of the Securities Exchange Act of 1934 to enforce compliance by its members with The Act and Rules promolgated thereunder and to supervise the activities of such members.

35. By virtue of the defendant New York Stock Exchange's wrongdoings abovementioned, plaintiff Marbury, has been damaged in the amount of Thirty Three Thousand Eight Hundred Twenty Seven Dollars and Seventy Seven Cents ($33,527.77) together with interest thereon from March 30, 1969.

COUNT V

36. That beginning in the summer of 1967, defendant Kohn met plaintiff Bader, and in order to induce the said plaintiff to purchase securities through him, falsely represented and held himself out to be a lawfully licensed registered representative, to said plaintiff, and represented to said plaintiff that he was authorized to transact buy and sell orders on behalf of the defendant, Wood, Walker & Co.

37. That plaintiff Bader did, in reliance on the above representations, place orders to buy and sell securities with defendant Wood, Walker & Co., through defendant Kohn, and defendant Wood, Walker & Co. did, in the ordinary course of business, execute all such transactions.

38. That plaintiff Bader did not deal with Wood, Walker & Co. through anyone other than defendant Kohn, and any instructions or directions in relation to said securities transactions and to the account of plantiff Bader were given to Kohn and acted upon by Wood, Walker & Co.

39. Defendant Wood, Walker & Co., knew or should have known that defendant Kohn was not a legally licensed representative, but nevertheless permitted him to hold himself out to the plaintiff Bader and others as such and permitted and allowed him to hold himself out as one authorized to transact buy and sell orders on behalf of the defendant Wood, Walker & Co. to the plaintiff Bader and others.

40. Defendant Wood, Walker & Co. knew or should have known at all times hereinmentioned that defendant Kohn was not licensed to act as a registered representative; yet upon information and belief, defendant Wood,

Walker & Co. did execute buy and sell orders through the aforesaid stock exchanges for the plaintiff Bader, and others, upon receipt of instructions from defendant Kohn.

41. That the representations by defendant Kohn that he was a duly authorized registered representative were, in fact, false and untrue and known by him to be false and untrue at the time said representations were made to plaintiff Bader and were made for the purpose of inducing this plaintiff, and others, to buy and sell certain securities through him.

42. Plaintiff Bader did instruct and order defendant Kohn to purchase and sell certain securities on certain dates as indicated in Schedule "B" attached hereto, in reliance on his misrepresentations.

43. That on certain dates, certain stocks were purchased through the defendant Wood, Walker & Co. (see Schedule "B") in reliance upon the defendant Kohn's relating to plaintiff Bader, and others, information about said securities as to their worthiness, value, and investment potential: the said securities were purchased upon reliance by the plaintiff Bader, and others, on the representation that the defendant Kohn was a lawfully licensed registered representative.

44. Defendant Kohn made such representations and, in fact, knew they were false and made them with the intent to deceive and defraud the plaintiff Bader, and others, and to induce plaintiff Bader, and others, to purchase the said securities and pay the sums of money therefor; and defendant Wood, Walker & Co. at the time the defendant Kohn made such false representations knew said representations were false and fraudulently executed buy and sell orders in behalf of the plaintiff and others with full knowledge that the defendant Kohn was not a lawfully

licensed registered representative, and did retain for its profit and gain the commissions charged the plaintiff and others in connection with said transaction.

45. Defendant Kohn in addition to representing himself to be a lawfully licensed representative also advised the plaintiff, Bader, and others, that he had personal knowledge of the investment potential of stocks traded in the over-the-counter market respectfully known as Commuter Airlines, Responsive Environment Corp., Capitol Holding and Stranrock Uranium; and his opinion the investment potential of these aforesaid stocks was based upon personal conversations and meetings with officers and other persons who had unique information as to the transactions of the corporations and their effect on the market price of the aforesaid stocks.

46. Upon information and belief at the time these representations were made, the said representations were false and, in fact, the defendant Kohn had no unique or special information of the investment potential of said corporations which would lead to an increase in the market price of said stocks.

47. Defendant Kohn at the time of the making of said representations, knew that they were false and that he made said representations with the intent to deceive the plaintiff Bader, and others, to induce it to purchase the aforesaid stocks, through his firm, the defendant Wood, Walker & Co.

48. Defendants' said actions, omissions and misrepresentations constitute a violation of Rule 10b5 of the Securities and Exchange Commission (17 C.F.R. 240.10b5) and Section 10b of the Securities Exchange Act of 1934 (15 U.S.C. 78[b]), in that they constituted the employment of a device, scheme and artifice to defraud, by the making of

untrue statements of material facts, and the failure to state certain material facts, so the statements made would not be misleading and constituted acts, practices in a course of business operating as a fraud upon the plaintiff Bader, and others.

49. Said acts, misrepresentations and omissions took place in connection with the purchase and sale of securities and operated in part through the mails, through regulated stock exchanges, and other instruments of interstate commerce.

50. That plaintiff was ignorant of the falsity of the representations of the defendant Kohn and that the defendant, Kohn, was not a legally licensed representative, but believed the representations to be true and relied upon the statements and representations made to it by the defendant as aforesaid including his representations as to special knowledge in relation to the securities which he induced plaintiff Bader to purchase.

51. Plaintiff was induced to and did purchase securities in the sum of approximately $24,902.25 in reliance on the above-mentioned representations. Plaintiff Bader still owns the securities purchased in reliance on the statements of the defendant Kohn and on these had losses (which are detailed in the attached Schedule "B").

52. By virtue of the defendants' above mentioned wrongdoings, plaintiff Bader has been damaged in the amount of $24,642.25, together with interest thereon from March 30, 1969.

COUNT VI

53. Plaintiff repeats, reiterates and realleges Paragraphs numbered "36" through "47" and "49" through "51" of Count V as if herein set forth at length.

54. Defendants' said actions, omissions and misrepresentations constitute a violation of Section 17a of the Securities Act of 1933 (15 U.S.C. 77q).

55. By virtue of the defendants' wrongdoings, abovementioned, plaintiff Bader has been damaged in the amount of $24,642.25, together with interest thereon from March 30, 1969.

COUNT VII

56. Plaintiff repeats, reiterates and realleges each and every one of the allegations contained in Paragraphs numbered "36" through "47" and "50" of Count V of this complaint, as if herein fully set forth.

57. The facts above stated also constitute actionable fraud under the laws of the State of New York. That based on the fraudulent acts above mentioned, plaintiff Bader did make the following purchases of security: 100 shares of Capital Holding purchased on December 27, 1968 for $687.50; 500 shares of Responsive Environments purchased on December 13, 1968 for $16,928.75; 500 shares of Commuter Airlines purchased on September 27, 1968 for a price of $6,312.50 and 200 shares of Stranrock Uranium purchased on or about the 6th day of January, 1969 for a price of $973.50.

58. That losses were suffered on each of these purchases of securities as follows: the 100 shares of Capital Holding purchased for $587.50 have a current value of approximately $00.00 for a loss of $687.50; the 500 shares of Responsive Environment purchased for $16,928.75 have a current value of approximately $200.00 for a loss of $16,728.75; the 500 shares of Commuter Airlines purchased for $6,312.50 have a current value of $00.00 for a loss of $6,312.50; the 200 shares of Stanrock Uranium bought for $973.50 have a current value of approximately $60.00 for a loss of $913.50.

59. All of the above losses were sustained as a result of the fraudulent acts of the defendant, resulting in a loss to plaintiff in the amount of $24,642.25, together with interest thereon from March 30, 1969.

COUNT VIII

60. Plaintiff repeats, reiterates and realleges Paragraphs numbered "36" through "47", "50", "51" and "52" as if herein set forth at length.

61. Defendant New York Stock Exchange failed, neglected and refused to fulfill its obligations under Sections 6 (a) (1)and 6 (d) of the Securities Exchange Act of 1934 to enforce compliance by its members with the Act and Rules promulgated thereunder and to supervise the activities of such members.

62. By virtue of the defendant New York Stock Exchange's wrongdoings abovementioned, plaintiff Bader, has been damaged in the amount of $24,642.25 together with interest thereon from March 30, 1969.

COUNT IX

63. That beginning in the summer of 1967, defendant Kohn met the plaintiff Jaffe, and in order to induce the said plaintiff to purchase securities through him, falsely represented and held himself out to be a lawfully licensed registered representative to said plaintiff, and represented to said plaintiff that he was authorized to transact buy and sell orders on behalf of the defendant Wood, Walker & Co.

64. That plaintiff, Jaffe, did, in reliance on the above representations, place orders to buy and sell securities with defendant Wood, Walker & Co., through defendant

Kohn, and defendant Wood, Walker & Co. did, in the ordinary course of business, execute all such transactions.

65. That plaintiff Jaffe did not deal with Wood, Walker & Co. through anyone other than defendant Kohn, and any instructions or directions in relation to said securities transactions and to the account of plaintiff Jaffe, were given to Kohn and acted upon by Wood, Walker & Co.

66. Defendant Wood, Walker & Co., knew or should have known that defendant Kohn was not a legally licensed representative, but nevertheless permitted him to hold himself out to the plaintiff Jaffe, and others, as such and permitted and allowed him to hold himself out as one authorized to transact buy and sell orders on behalf of the defendant Wood, Walker & Co. to the plaintiff, Jaffe, and others.

67. Defendant Wood, Walker & Co. knew, or should have known, at all times hereinmentioned, that defendant Kohn was not licensed to act as registered representative; yet, upon information and belief, defendant Wood, Walker & Co. did execute buy and sell orders through the aforesaid stock exchanges for the plaintiff Jaffe, and others, upon receipt of instructions from defendant Kohn.

68. That the representations by defendant Kohn that he was a duly authorized registered representative were, in fact, false and untrue and known by him to be false and untrue at the time said representations were made to plaintiff and others, to buy and sell certain securities through him.

69. Plaintiff Jaffe did instruct and order defendant Kohn to purchase and sell certain securities on certain dates as indicated in Schedule "C" attached hereto, in reliance on his misrepresentations.

70. That on certain dates, certain stocks were purchased through the defendant Wood, Walker & Co. (see Schedule "C") in reliance upon the defendant Kohn's relating to plaintiff Jaffe, and others, information about said securities as to their worthiness, value and investment potential, the said securities were purchased upon reliance by the plaintiff Jaffe, and others, that the defendant Kohn was a lawfully licensed registered representative.

71. Defendant Kohn made such representations and, in fact, knew they were false and made them with the intent to deceive and defraud the plaintiff Jaffe, and others, and to induce plaintiff Jaffe, and others, to purchase the said securities and pay the sums of money therefor; and defendant Wood, Walker & Co., at the time the defendant Kohn made such false representations, knew said representations were false and fraudulently executed to buy and sell orders in behalf of the plaintiff, and others, with full knowledge that the defendant Kohn was not a lawfully licensed registered representative, and did retain for its profit and gain the commissions charged the plaintiff and others in connection with said transaction.

72. Defendant Kohn in addition to representing himself to be a lawfully licensed representative, also advised the plaintiff Jaffe, and others, that he had personal knowledge of the investment potential of stocks traded in the over-the-counter market and on the American Stock Exchange, respectfully known as D.W.G. Corporation, Responsive Environment Corp., Universal Container, Commuter Airlines, Automatic Radio and Standard Dredging; and his opinion of the investment potentials of these aforesaid stocks was based upon personal conversations and meetings with officers and other persons who had unique information as to the transactions of the corporations and their effect on the market price of the aforesaid stocks.

73. Upon information and belief at the time representations were made, the said representations were false, and, in fact, the defendant Kohn had no unique or special information of the investment potential of said corporation which would lead to an increase in the market price of said stocks.

74. Defendant, Kohn at the time of the making of said representations, knew that they were false and that he made said representations with the intent to deceive the plaintiff Jaffe, and others, and to induce him to purchase the aforesaid stocks, through defendant Kohn's firm, the defendant Wood, Walker & Co.

75. Defendants' said actions, omissions and misrepresentations constitutes a violation of Rule 10b5 of the Securities Exchange Act of 1934 (15 U.S.C. 78; [b]), in that they constituted the employment of a device, scheme and artifice to defraud, by the making of untrue statements of material facts, and the failure to state certain material facts, so the statements made would not be misleading and constituted acts, practices in a course of business operating as a fraud upon the plaintiff Jaffe, and others.

76. Said acts, misrepresentations and omissions took place in connection with the purchase and sale of securities and operated in part through the mails, through regulated stock exchanges, and other instruments of interstate commerce.

77. That plaintiff was ignorant of the falsity of the representations of the defendant Kohn, and that the defendant Kohn was not a legally licensed representative, but believed the representations to be true and relied upon the said statements and representations made to it by the defendant, as aforesaid, including his representations as to special knowledge in relation to the securities which he induced plaintiff Jaffe to purchase.

78. Plaintiff was induced to and did purchase securities in the sum of approximately $27,964.46 in reliance on the abovementioned representations. Plaintiff Jaffe sold certain of the said securities suffering losses on said securities in the sum of $4,084.25; plaintiff Jaffe still owns certain securities purchased in reliance on the statements of the defendant Kohn, and on these had losses of $7,790.07 (losses are detailed in the attached Schedule "C").

79. By virtue of the defendants' abovementioned wrongdoings, plaintiff Jaffe has been damaged in the amount of $11,874.32, together with interest thereon from March 30, 1969.

COUNT X

80. Plaintiff repeats, reiterates and realleges Paragraphs numbered "63" through "74" and "76" through "78" of Count IX as if herein set forth at length.

81. Defendants' said actions, omissions and misrepresentations constitute a violation of Section 17a of the Securities Act of 1933 (15 U.S.C. 77q).

82. By virtue of the defendants' wrongdoing, abovementioned, plaintiff Jaffe has been damaged in the amount of $11,874.32, together with interest thereon from March 30, 1969.

COUNT XI

83. Plaintiff repeats, reiterates and realleges each and every one of the allegations contained in Paragraphs numbered "63" through "74" and Paragraph "77" of Count IX of this complaint, as if herein fully set forth.

84. The facts above stated also constitute actionable fraud under the laws of the State of New York. That based

on the fraudulent acts abovementioned, plaintiff Jaffe did make the following purchases of security: 500 shares of D.W.G. Corporation, purchased on December 10, 1968 for $5,716.25; 100 shares of Responsive Environments purchased on December 3, 1968 for $3,385.75; 400 shares of Standard Dredging purchased in November, 1968 for a price of $7,514.63; 300 shares of Universal Container purchased on or about the 27th day of February, 1969 for a price of $9,215.07; 300 shares of Automatic Radio purchased on January 7, 1960 for a price of $7,406.07; and 400 shares of Commuter Airlines purchased on July 11, 1969 for a price of $3,941.76.

85. That losses were suffered on each of these purchases of securities as follows: the shares of D.W.G. Corporation purchased for $5,716.25 were sold for $1,803.75 for a loss of $3,912.50; the 100 shares of Responsive Environment purchased for $3,385.75 were sold for $3,209.75, for a loss of $176.00; the 400 shares of Standard Dredging purchased for $7,514.63 were sold on January 23, 1967 and March 12, 1969 for $5,599.86 for a loss of $1,914.77; the 300 shares of Universal Container bought on February 27, 1969 have a current value of approximately $1,425.00 for a loss of $7,790.07; the 400 shares of Commuter Airlines purchased for $3,941.76 were sold for $3,917.00, for a loss of $24.76; and 300 shares of Automatic Radio purchased for $7,406.07 were sold for $7,241.10, for a loss of $164.97.

86. All of the above losses were sustained as a result of the fraudulent acts of the defendant, resulting in a loss to plaintiff in the amount of $11,874.32, together with interest thereon from March 30, 1969.

COUNT XII

87. Plaintiff repeats, reiterates and realleges Paragraphs numbered "63" through "74" and "76", "77", "78" of Count IX as if herein set forth at length.

88. Defendant New York Stock Exchange failed, neglected and refused to fulfill its obligations under Section 6 (a) (1) and 6 (d) of the Securities Exchange Act of 1934 to enforce compliance by its members with the Act and Rules promulgated thereunder and to supervise the activities of such members.

89. By virtue of the defendants' wrongdoings abovementioned, plaintiff Jaffe has been damaged in the amount of $11,874.32, together with interest thereon from March 30, 1969.

WHEREFORE,

1. Plaintiff Marbury demands judgment in the amount of Thirty Three Thousand Eight Hundred Twenty Seven Dollars and Seventy Seven Cents ($33,527.77) on Counts numbered "I" through "IV" of the complaint.

2. Plaintiff Bader demands judgment in the amount of Twenty Four Thousand Six Hunded Forty Two Dollars and Twenty Five Cents ($24,642.25) on Counts numbered "V" through "VIII" of the complaint.

3. Plaintiff Jaffe demands judgment in the amount of Eleven Thousand Eight Hundred Seventy Four Dollars and Thirty Two Cents ($11,874.32) on Counts numbered "IX" through "XII" of the complaint.

4. All of the above with interests and costs.

HAUSER & ROSENBAUM, P. C.
By Noel W. Hauser, a Member of the Firm
26 Court Street
Brooklyn, New York 11242
(212) 522-3300

Schedule A.

MARBURY MANAGEMENT, INC.

Schedule of Purchases and Sales of Securities
through Alfred Kohn and Wood Walker & Co.

No. of Sales	Name of Stock	Date Purchased	Purchase Price	Date Sold	Sales Price	Net Loss
500	Unexcelled, Inc.	1/20/69	$22,205.00	3/26/69	$13,312.23	$8,892.77
				TOTAL NET LOSS ON SECURITIES SOLD.....		$8,892.77
				Market Value		
1000	D.W.G. Corp.	8/27/68	$14,750.00	Presently Held	$ 3,000.00	$11,750.00
100	Responsive Environment	12/6/68	3,385.75	Presently Held	200.00	3,185.00
100	Universal Container	3/26/69	12,406.25	Presently Held	2,700.00	9,706.25
				TOTAL UNLIQUIDATED LOSS ON SECURITIES PRESENTLY HELD.....		$33,527.00

Schedule B.

HARRY BADER

Schedule of Purchases and Current Market Value of Securities purchased through Alfred Kohn and Wood Walker & Co.

No. of Sh.	Name of Stock	Date Purchased	Purchase Price	Mkt. Value	Loss
500	Responsive Environments	12/13/68	$16,928.75	$200.00	$16,728.75
100	Captial Holding	12/27/68	687.50	00.00	687.50
500	Commuter Airlines	9/27/68	6,312.50	00.00	6,312.50
200	Stranrock Uranium	1/6/69	973.50	60.00	913.50
					$24,642.50

Schedule C.

HARVEY JAFFE

Schedule of Purchases and Sales, and Current Value of Securities sold through Alfred Kohn and Wood Walker & Co.

No. of Sh.	Name of Stock	Date Purchased	Purchase Price	Date Sold	Sales Price	Net Loss
400	Commuter Airlines	7/11/68	$ 3,941.76	1/23/69	$3,917.00	$ 24.76
300	Standard Dredging	11/14/68	5,778.00	3/12/69	3,865.78	1,912.22
100	Standard Dredging	11/29/68	1,736.63	1/23/69	1,734.08	2.55
100	Respon-sive Envi-ronment	12/3/68	3,385.75	2/4/69	3,209.75	176.00
500	D.W.G. Crop.	12/10/68	5,716.25	3/13/69	3,912.50	1,803.75
300	Automatic Radio	1/7/69	7,407.07	2/6/69	7,241.10	164.97
						$4,084.25
				Market Value		Loss
100	Universal Container	2/27/69	9,215.07	Presently Held	1,425.00	7,790.07
						$11,874.32

Decision By District Judge Lee P. Gagliardi on July 19, 1977, Dismissing the Complaint against Wood, Walker & Co. (TT pp. 221a-223a).

The Court: The gravamen of the complaint is a violation of Section 10(b) of the Securities & Exchange Act and Rule 10(b)-5 as promulgated pursuant thereto.

It is undisputed that Alfred Kohn was employed by the defendant Wood, Walker & Company. I find that he was employed as a trainee and accepting the plaintiffs' facts in their most favorable light, as I must do on a motion of this kind, I think the evidence in its most favorable light to the plaintiffs is that during the course of his employment with Wood, Walker & Company the defendant Alfred Kohn did solicit business from the three plaintiffs here and made various reprsentations to each of the plaintiffs with respect to each of the issues which they purchased as set forth in Schedules A, B and C annexed to the complaint.

I further accept for the purposes merely of the motion with respect to Wood, Walker the testimony of the plaintiffs to the effect that Alfred Kohn held himself out as a registered representative or a qualified broker and that except for these representations they would not have made the purchases which they did nor would they have continued to hold the stock for as long as they indicated they held it, except, of course, with respect to the 300 shares of Standard Dredging purchased by plaintiff Harvey Jaffe.

I find that in its most favorable aspect the plaintiffs may have established negligence on the part of the defendant Wood, Walker. I find, however, that the plaintiffs have not sustained the burden of proof by a fair preponderence of the credible evidence in this respect and secondly, with respect to a violation of Section 10-B and Rule 10(b)-5, I find that the plaintiffs have failed to show any proof whatsoever which appears to be required under the decision of Ernst & Ernst and there is no evidence whatsoever in this case of any participation in behalf of defendant Wood,

Walker to manipulate with fraud or to in any way indicate that they intended to deceive their customers, particularly the three plaintiffs involved in this case.

For these reasons the complaint against the defendant Wood, Walker is dismissed without costs, and the clerk shall enter judgment in accordance with the decision herewith.